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ECONOMIC REPORT

FALL 1982

CALIFORNIA OUTLOOK EDITION AND U.S. ECONOMIC UPDATE

SECURITY PACIFIC NATIONAL BANK

CALIFORNIA OUTLOOK EDITION AND U.S. ECONOMIC UPDATE

FALL 1982

Number 66

This report highlights the near-term outlook for the California economy through 1983, and includes a near-term update of the U.S. economy.

The next issue of the ECONOMIC REPORT will discuss the INTERNATIONAL OUTLOOK. It is scheduled for release in January, 1983.

The ECONOMIC REPORT may be received on a regular basis upon request to:

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CONTENTS

2 THE CALIFORNIA NEAR-TERM OUTLOOK:
Examines the California economy in terms of Gross State Product, employment, personal income, consumer spending, and trends in consumer prices.

7 CALIFORNIA INDUSTRY TRENDS:
Evaluates the strengths and weaknesses of California's major industries and assesses their potential for growth through 1983.

15 TRENDS IN CALIFORNIA'S REGIONS:
Discusses the current and anticipated levels of economic activity for the state's three principal geographic areas, Southern, Central and Mountain, and Northern Coastal.

23 UNITED STATES NEAR-TERM OUTLOOK:
Presents a review and update of the U.S. economy and provides assumptions for monetary and fiscal policy, financial developments, consumer and business spending, and the international economy.

THE CALIFORNIA NEAR-TERM OUTLOOK

OVERVIEW

By the middle of 1982, the California economy, based upon the output of goods and services produced, had been in a recession for some six months. Although the second half of 1982 is expected to record positive rates of economic growth, pervasive weakness will remain until well into 1983. Tracking the recent history of economic activity in the state shows that in current-dollar terms output in the state will have expanded by only about 3 percent from the fourth quarter of 1980 through the third quarter of 1982. The record is worse if adjusted for inflation. Preliminary data for the second quarter of 1982 show that in real terms the state's economy likely ended the latest recession at a level a mere 1 percentage point above the level attained in the fourth quarter of 1979. Indeed, the second quarter, 1982, level of real economic output was an estimated 0.2 percentage point below where it had been a year and a half earlier.

Economic activity in the state should be stimulated somewhat in the second half of 1982 by the reduction in personal income tax rates, a lower-inflation environment, and an initial — although perhaps temporary — decline in interest rates. While there is therefore some slight reason for optimism for the second half of 1982, there is little reason to believe that the California economy will be leaping forward until the second half of 1983 A revitalization of a number of the state's key industrial groups will take several quarters to get underway and several more quarters to show meaningful results. As presently forecast, the California economy will register rates of real economic growth that are in the neighborhood of 3 to 4 percent from the fourth quarter of 1982 through the first half of 1983. During the second half of 1983, present projections for real economic growth show rates that could range as high as 5.5 percent to over 6 percent.

GROSS STATE PRODUCT AND PERSONAL INCOME
(Billions of Dollars)
Quarterly Detail, 1982-1983

	1982F				1983F			
	I	II	III	IV	I	II	III	IV
Gross State Product	366.4	369.9	376.2	385.1	394.6	404.6	417.2	430.2
1972 Dollars	176.6	175.8	176.1	177.6	178.9	180.8	183.6	186.2
Personal Income	307.5	310.6	317.1	324.5	331.5	338.8	348.9	359.1
Disposable Personal Income	259.6	261.4	270.8	276.8	282.1	288.0	299.8	307.9
1972 Dollars	125.1	124.9	127.2	128.2	128.1	128.8	132.2	133.9
Annual Rates of Change:								
Gross State Product	–3.5	3.9	7.0	9.8	10.3	10.5	13.1	13.0
1972 Dollars	–6.8	–1.8	0.7	3.5	3.1	4.2	6.4	5.7
Personal Income	1.3	4.0	8.6	9.7	8.9	9.0	12.6	12.2
Disposable Personal Income	2.7	2.9	15.0	9.3	7.8	8.6	17.5	11.2
1972 Dollars	–2.1	–0.5	7.6	3.1	–0.2	2.3	10.9	5.1

F = Forecast

In addition to the tax cuts, lower rates of inflation, and a relatively lower level of interest rates, on average, than that which prevailed for much of the past few years, additional influences will be helping to support California's economic recovery. For example, a modest pickup in sales of consumer and business electronic goods will couple with the effects of increased defense spending to assist in the recovery of the aerospace/high-technology industry. The state's agricultural industry will be assisted by the less rapid rise in financing and production costs and by the anticipated improvement in foreign markets for farm products. And the construction industry should begin to establish a slow recovery as 1983 progresses. Although the state's economy will have been in a recovery phase for six quarters as of the end of 1983, the presently estimated level of real economic output at that time will still be only a modest 3.5 to 4 percentage points above the level attained during the last quarter of 1981, just prior to the latest recession's initial quarter.

EMPLOYMENT TRENDS

California labor market trends have traditionally offered an excellent window through which to view the overall direction and strength of the state's economy. In particular, developments in the establishment survey of nonagricultural industries' employment totals provide a very good measurement of the sectoral impact of business cycles. Looking first at the broader measure of the state's employment scene, the percentage of persons in the civilian labor force unable to find work, it is clear that the general trend in California economic activity has run a course quite like that of the nation as a whole. The state's unemployment rate began to rise in the third quarter of 1981, following a low point of 6.9 percent in the second quarter of that year. Each subsequent quarter registered increases in the statewide unemployment rate, with the anticipated peak occurring in the third quarter of 1982, at a quarterly average level in the neighborhood of 10.3 percent. Interestingly, California's unemployment rate began rising in the same quarter in which the nation entered the latest recession, and as of July, 1982, the national and state unemployment rates were 9.8 and 10.5 percent, respectively. Even after an expected six quarters of economic expansion, from the second half of 1982 through the last quarter of 1983, the state's unemployment rate is expected to be above 9 percent.

The inability of the state's economy to generate a sufficient number of jobs to accommodate the sizable growth in the state's civilian labor force was compounded greatly by the past recession. Job losers joined the ranks of new entrants and re-entrants into the labor force and were caught in the competiton for employment with large numbers of new migrants moving into the state. A glance at the average level of total employment in the state during 1979, compared with that expected for 1983, shows that employment will have grown only 4.9 percent, or some 518 thousand jobs, over that five-year period. The civilian labor force, on-the-other-hand, will have expanded about 9.3 percent, or by one million potential workers. Total inmigration, alone, during that period, is expected to exceed 1.1 million persons — a large number of whom will be of working age.

As has generally been the case in past business cycles, unemployment increases tend to lag the overall slowdown in business activity as firms attempt to retain experienced workers until the length and severity of the downturn can be established. Firms realize that it can prove difficult and costly to rebuild their workforce with qualified people once the economy becomes healthy again. The logical move, of course, is to not be too hasty in reducing payroll numbers until it is certain that the business downturn will be lengthy. The opposite thinking typically prevails as an economic recovery begins. Firms are not anxious to add large numbers of workers to their workforce, or to recall laid-off workers, until they are reasonably certain that the recovery will be sustained. Even then, payroll additions are generally slow and are matched well to sales increases or to inventory rebuilding. As a result of that philosophy, unemployment often continues to rise for several months after the trough of a recession has been reached, and it also takes several months for the unemployment rate to make noticeable declines.

The trend in nonagricultural wage and salary employment during the past business cycle has been essentially parallel to that of the state's civilian employment totals. Nonfarm employment peaked in the third quarter of 1981, at approximately 10.1 million, and is expected to show a decline of over 1 percentage point by the third quarter of 1982. That percentage decline would represent a loss of more than 128 thousand jobs. Based upon present projections of the average level of nonfarm employment in the state during the fourth quarter of 1983, which incorporates a substantial improvement in

CALIFORNIA EMPLOYMENT, 1981-1983
(Thousands)

	1981A	1982F	1983F	Annual Growth Rates 1980-81	1981-82	1982-83
Civilian Labor Force	11,780	12,102	12,312	1.7	2.7	1.7
Total Civilian Employment	10,908	10,926	11,083	1.1	0.2	1.4
Unemployment	872	1,176	1,229	10.4	34.9	4.5
As % of Labor Force	7.4	9.7	10.0	—	—	—
Nonagricultural Wage & Salary Workers	10,037	9,990	10,135	1.9	–0.5	1.4
Mining	49	50	47	12.2	2.5	–5.0
Construction	432	384	372	–3.0	–11.1	–3.0
Manufacturing	2,028	1,980	2,010	1.0	–2.4	1.5
Nondurable Goods	651	649	654	2.1	–0.4	0.9
Durable Goods	1,377	1,331	1,356	0.5	–3.4	1.9
Aerospace	634	626	641	1.8	–1.3	2.4
Transportation & Public Utilities	554	553	553	1.4	–0.1	0.0
Trade	2,317	2,339	2,406	2.2	1.0	2.9
Finance, Insurance & Real Estate	645	647	649	3.6	0.2	0.3
Services	2,249	2,305	2,392	4.3	2.5	3.8
Government	1,763	1,733	1,705	0.0	–1.7	–1.6
Federal	324	322	321	–3.1	–0.6	–0.4
State & Local	1,440	1,411	1,385	0.7	–2.0	–1.8

A = Actual F = Forecast

CALIFORNIA EMPLOYMENT
Quarterly Detail, 1982-1983
(Thousands, Seasonally Adjusted)

	1982F				1983F			
	I	II	III	IV	I	II	III	IV
Civilian Labor Force	11,971	12,134	12,145	12,158	12,196	12,260	12,350	12,441
Total Civilian Employment	10,892	10,990	10,900	10,922	10,951	11,004	11,121	11,256
Unemployment	1,079	1,145	1,245	1,236	1,245	1,256	1,229	1,185
As % of Labor Force	9.0	9.4	10.3	10.2	10.2	10.2	10.0	9.5
Nonagricultural Wage & Salary Workers	10,035	9,982	9,962	9,982	10,009	10,059	10,171	10,300
Mining	52	51	49	48	47	47	48	48
Construction	402	383	378	372	373	370	370	376
Manufacturing	2,002	1,979	1,968	1,971	1,979	1,995	2,018	2,046
Nondurable Goods	656	645	647	649	650	652	654	659
Durable Goods	1,346	1,334	1,321	1,322	1,329	1,343	1,364	1,387
Aerospace	628	629	621	624	628	636	644	655
Transportation & Public Utilities	557	555	551	550	549	550	554	560
Trade	2,337	2,336	2,339	2,345	2,358	2,383	2,422	2,462
Finance, Insurance & Real Estate	650	647	646	644	643	644	649	658
Services	2,282	2,293	2,310	2,336	2,352	2,369	2,406	2,443
Government	1,753	1,739	1,722	1,716	1,707	1,702	1,705	1,707
Federal	326	321	321	320	320	320	321	321
State & Local	1,427	1,418	1,402	1,396	1,387	1,382	1,384	1,386

F = Forecast

the aerospace industries, the recessionary decline in nonagricultural jobs will be far more than offset during the first 18 months of the recovery. Indeed, over the first year-and-a-half of the recovery, nonfarm payroll employment gains are expected to total well over 300 thousand and will likely exceed the pre-recession peak by more than 2 percent.

With few exceptions, the chill over California's industries during the past recession has been pervasive, and in some cases devastating. In addition to the severe damage done to the construction industry, nearly all categories of manufacturing, including both durable and nondurable goods, have registered sizable employment losses. The mining industry in the state, which has been a major beneficiary in the push to develop or to expand energy supplies, is presently undergoing a sharp contraction and will probably experience significant employment declines in the year ahead. Nonmanufacturing employment sectors, such as transportation and public utilities, and government, remain in a period of enforced restraint due to reduced funding and efforts to curtail the growth in public expenditures. Positive employment growth has been maintained in the finance, insurance, and real estate category, despite the catastrophe in the real estate markets, because continued expansion in the other two components has more than offset the decline in real estate related jobs. And, tourism and personal and financial services have supported the level of total employment in the service sector.

Excluding mining and government employment, which are expected to experience ongoing contractions in payroll numbers through 1983, the condition of the state's remaining primary-industry employment sectors should improve over that of 1982. However, the overriding influence of a relatively slow expansion in real economic activity for at least the first half of 1983 will preclude a robust recovery for most industries. In the sections that follow, the outlook for a number of the state's primary-industry groups will be examined at length, including: construction, aerospace, agriculture, international trade, banking, and others.

INCOME AND SPENDING

The effects of the statewide weakness in economic activity and poor labor market performance show up clearly in the data measuring personal income and consumer spending. As presently projected, personal income in the state will expand less than 8 percent for all of 1982, compared with a gain of 12.5 percent for the prior year. Consumer spending, as measured by taxable sales, will be up less than 2 percent from the prior year's level. The slight gain in employment expected for the second half of 1982 will combine with the personal tax cut, the Social Security benefit increase, and an improved inflation picture to promote rather good gains in real disposable personal income for the last six months of the year. However, the likelihood of future tax increases, particularly at the federal level, and the anticipated uptick in consumer prices — although modest by recent standards, argue that real disposable personal income gains in the state will slow sharply in the first half of 1983. Since it is assumed that the 1983 tax cut will become effective during the second half of that year, a second surge in real disposable personal income is expected.

Based upon the preceding assumptions regarding personal income gains, particularly after adjusting for personal taxes and inflation, the outlook for consumer spending in the state brightens considerably following the dismal performance of the first half of 1982. Consumer spending should be growing in the neighborhood of 12 percent during the second half of 1982 and even

POPULATION AND PERSONAL INCOME

	1981A	1982F	1983F
Population (Thousands)	24,046P	24,437	24,837
Net Inmigration (Thousands)	191P	177	217
Personal Income ($ Billions)	291.9	314.9	344.6
Per Capita Personal Income ($)	12,139P	12,886	13,874
Disposable Personal Income ($ Billions)	245.0	267.2	294.4
1972 Dollars	122.9	126.3	130.8
Annual Rates of Change:			
Population	1.6	1.6	1.6
Net Inmigration	–24.8	–7.3	22.6
Personal Income	12.5	7.9	9.4
Per Capita Personal Income	11.2	6.2	7.7
Disposable Personal Income	12.0	9.0	10.2
1972 Dollars	3.4	2.8	3.5

A = Actual F = Forecast P = Preliminary

stronger gains are expected for 1983. For 1983 as a whole, taxable sales will total almost 12 percent higher than the previous year's figure. Importantly, sales of major consumer durable goods, such as automobiles and "big-ticket" home appliances, are projected to experience progressively stronger sales in the quarters ahead. A moderating influence on consumer durable goods spending, however, will be the continued sluggish market for both new and existing houses, since household moves tend to trigger additional purchases of major consumer durables.

GROSS STATE PRODUCT, TAXABLE SALES, AND PRICES

	1981A	1982F	1983F
Gross State Product ($ Billions)	355.2	374.4	411.7
1972 Dollars ($ Billions)	178.3	176.5	182.4
Taxable Sales ($ Billions)	154.3	156.8	175.2
Consumer Price Index	276.6	297.9	316.4
Annual Rates of Change:			
Gross State Product	12.6	5.4	10.0
1972 Dollars	3.1	–1.0	3.3
Taxable Sales	8.7	1.6	11.7
Consumer Prices	10.8	7.7	6.2

A = Actual F = Forecast

CONSUMER PRICE TRENDS

California experienced a substantial moderation in the rate of consumer price increases during most of the first half of 1982. At mid-year, however, the state Consumer Price Index began to move into the double digit range of increases, after annualizing the month-to-month rises. Home purchase and mortgage financing costs were major contributors to the upswing. In addition, costs for medical care — a problem area for some time — continued to move up substantially. Price increases for personal transportation also spurted ahead around the middle of the year as a result of higher than typical increases in used car prices — reflecting, in part, consumer reluctance to purchase new cars at current price and financing levels. Upward adjustments in auto insurance rates put additional pressure on the cost component for operating a personal automobile, and higher prices for gasoline furthered the boost in that component.

The mid-year jump in consumer prices is expected to abate somewhat in the second half of the year but will result in a year-over-year increase in prices of 7.7 percent, slightly higher than generally expected in earlier forecasts. The rate of increase in consumer prices for California during the second half of 1982, continuing through most of 1983, should be well below double-digit levels. For all of 1983, California's Consumer Price index is foreseen rising only 6.2 percent above 1982's level. That rate of increase would generate the best performance in California consumer price trends since 1976, when prices rose 6.1 percent.

There are a number of influences expected to combine to achieve the slower pace in consumer price rises. Sluggish home sales will result in only minor increases in home prices and the anticipated easing in financing costs will help slow the rise in the housing component. The outlook for energy supplies and prices for the next several quarters suggests that energy price increases at the consumer level will be moderate compared with the past few years. Costs for medical care, on-the-other-hand, will continue to rise at a rate exceeding that for most other major components of the CPI, precluding even better results in the overall lowering in consumer prices.

The scheduled changed in methodology for computing the CPI, effective in 1983, may actually result in greater increases in the housing component than might be the case using the old method. Rather than reflecting the present weakness in home prices and the expected decline in mortgage rates, the new method will attempt to measure a rental cost for housing that could lead to a higher reading, at least temporarily. On-the-whole, however, the new methodology should provide a less volatile and more representative measure of the cost of housing in the years ahead. ■

CALIFORNIA INDUSTRY TRENDS

AEROSPACE

California's aerospace industry, which is actually a combination of several related industries ranging from office and computing machines to guided missiles and space vehicles, represents a significant contribution to the state's economy. In terms of wage and salary employment, the aerospace sector provides nearly one-third of all manufacturing jobs. The industry is highly dependent upon three main categories of end-users: business and consumer electronics, commercial airlines, and national defense. With the exception of the latter, the aerospace industry has recently experienced substantial difficulties resulting from declining sales revenues and sharply rising costs.

For the most part, the decline in sales of business and consumer electronic products has reflected the general recession in the domestic market and weakness in many primary export markets for U.S. electronics products. In addition to the recession-induced decline in sales, however, high financing costs have cut deeply into profits, and the growing influence of foreign competition in both overseas and U.S. markets has eroded both the actual and potential domestic producers' market share. The cyclical recovery in the U.S. economy will abate, at least temporarily, a big part of the weakness in business and consumer electronics sales, but the problem of increasing foreign competition may be just getting underway. At present, the semiconductor industry appears to be hardest hit by offshore competition, but the increased sophistication and emphasis on research and development abroad — in Europe and Asia, for example — suggests that other high-technology markets may soon be facing stiffened competition as well.

The problems of the commercial airline industry are well documented as well as diverse. Not only has the recession resulted in fewer passenger miles being flown, but the increased competition resulting from airline deregulation has led to declining revenues per passenger-mile. Many industry observers suggest that the industry could have adjusted to deregulation — even with the recession — far more easily and quickly had it not been for the sharp escalation in costs for fuel, financing, labor, and other operating-expense items, that occurred virtually concurrently. In its present state, the commercial airline industry will likely require another 18 to 24 months to overcome the multitude of hurdles it faces. On that basis, it seems unlikely that the aerospace manufacturing sector will benefit much from the initial rebuilding stages of the domestic airline industry, at least until late 1983 or early 1984.

The defense component of the aerospace manufacturing sector continues to offer both current support as well as the brightest near-term prospects for the industry. During 1981 and 1982, the aerospace industry's defense-related components began to feel the benefit of the United State's determination to reverse its eroding military superiority. In 1983, it is generally expected, the defense build-up should begin to result in substantial capital investment and new job opportunities in California. Presently, Pentagon outlays for 1983 are projected to exceed 1982 levels by 7 to 8 percent, after adjusting for inflation. Additionally, the growth in real defense procurement expenditures is seen rising near that range for the next several years. There are several major Pentagon projects scheduled that will have either direct or potentially significant secondary impact upon the state's aerospace manufacturing sector. Among those, production of the B-1 bomber and development of the Stealth bomber offer significant opportunities for the California aerospace industry. Also, expansion of the Navy's aircraft carrier and nuclear submarine fleets is being pushed, as are plans for deploying the Cruise missile and for a new generation of ICBMs. Several other additions and improvements to the nation's strategic forces are at varying stages in the planning or production pipelines.

Many of the Pentagon's projects will not have much of an immediate impact on California's aerospace industry, but the state will enjoy some employment gains in 1983 that will result from the defense buildup. That strength, even though relatively minor compared with that expected for subsequent years, will help to offset the weakness in the commercial airline industry and will add to the sluggish, but positive, growth in the business and consumer electronics market. For 1983 as a whole, the aerospace industry is projected to increase payroll numbers on the order of 2.5 percent, or

CALIFORNIA BANKING FORECAST

	1981P	1982F	1983F	Annual Growth Rates 1980-81	1981-82	1982-83
Gross Loans * ($ Billions)	118.6	129.5	145.4	8.4	9.2	12.3
Commercial & Industrial	35.5	40.9	46.1	10.3	15.1	12.7
Real Estate	51.2	54.2	61.9	11.3	5.8	14.2
All Other	31.9	34.4	37.4	2.2	7.9	9.0
Total Deposits	138.3	153.3	169.5	7.9	10.9	10.6
Demand	37.4	37.0	40.5	-8.1	-1.2	9.4
Time & Savings	100.9	116.3	129.0	15.3	14.0	10.9
Loan-to-Deposit Ratio (%)	85.8	84.5	85.8			

*Minus loans to domestic commercial banks P = Preliminary F = Forecast

over 15 thousand workers. That employment gain represents an increase in workers that is nearly double the number of industry job losses during 1982, and places the industry employment total almost 7 thousand above the 1981 level.

BANKING

The tight-credit environment that has prevailed for several quarters has contributed to the broad weakness in the California economy and has also had a significant influence on the state's commercial banking industry. The high cost of funds to financial institutions, whether acquired through deposits or purchased, has caused the industry to maintain lending rates far above levels that had been anticipated a year ago. Consumer borrowing and real estate lending have both been weak, and commercial and industrial credit extensions, particularly short-term, have expanded sharply. Gross loans generated by the California commercial banking industry are expected to show a 1982 increase of 9.2 percent, barely above the 1981 gain. It is presently projected that the summer-fall decline in interest rates will be reversed by late 1982, and that rates in early 1983 may be 150 to 200 basis points above the summer-fall trough. (Security Pacific Bank's financial assumptions are presented in detail in the Near-term U.S. Outlook section.)

Commercial and industrial loans were the fastest growing category for the first half of 1982 as firms struggled with declining revenues and poor profit performance. Borrowing to meet day-to-day operating expenses, finance inventories, and cover payrolls has been necessitated by their reduced cash-flow and the erosion of retained earnings. The moderate expansion of the state's economy in the second half of 1982 and through 1983 will help resolve profitability and cash-flow difficulties, but the sizable amount of short-term debt already burdening California's commercial and industrial firms will likely present a difficult problem for some time to come. The high cost of debt financing has precluded most firms from entering the bond market because they are unwilling to be saddled with long-term obligations at current interest rates. Equity financing is also unpalatable given the current weakness in stock prices. Most firms feel that their best course is to continue to roll-over their existing short-term debt until long-term interest rates decline and stock prices strengthen. Importantly, the financial industry is becoming edgy about the severely weakened financial position of many firms, the sharp rise in bankruptcies, and the stretching-out of debt repayment. The commercial banking industry's concern for credit quality may mean an increase in the number of firms that are frozen out of the credit market in the months ahead.

Total deposits at California's commercial banks have continued to benefit from the higher rate of personal saving that has been experienced for the past several quarters. However, the compositon of deposits has tended to shift from checking accounts into time deposits, representing a substantial increase in the cost of funds. Moreover, the expansion of interest-bearing checking accounts and various forms of NOW-type accounts represent a long-term trend in the industry that will raise the cost of obtaining deposits. In addition, commercial banks have faced strong competition from money market funds and have had to develop a wide range of higher-yielding, competing instruments that have increased further the cost of attracting deposits.

During the anticipated expansion in the California economy in the period ahead it is likely that time and savings deposits will grow less rapidly and that transactions balances will begin to rise. The shift in deposit composition should result from the need to increase transactions balances to meet the anticipated growth in consumer spending. Also, some observers feel that the "flight to quality" from uninsured accounts — such as money market funds — into insured saving accounts will help strengthen the overall deposit condition of commercial banks in the state and will help broaden the supply of lendable funds in the California financial system. The loan-to-deposit ratio for the California commercial banking system should remain in the 84 to 86 percent range through 1983.

CONSTRUCTION

Residential Outlook

The California construction industry may well have the dubious honor of being hardest hit among all major industry groups in the state during the present recession. To make matters worse, the residential building industry began to slide in 1978, and has fallen to depths not anticipated by even the most pessimistic forecasts of even fairly recent history. The peak just prior to the declining years of the present building cycle occurred in 1977, when 270.6 thousand residential units were authorized for construction in the state. Security Pacific Bank's projection for 1982 building permit authorizations shows a total of only 78.1 thousand residential units for the year; a decline of more than 71 percent from the 1977 peak. That forecast assumes that the mid-year surge in permit authorizations was a result of builders' efforts to beat the cost-adding implementation of new environmental regulations, and that since those regulations have been postponed until July, 1983, much of the permit bulge will be cancelled. A large proportion of the cancelled permits will likely not be resubmitted until 1983.

While that 1982 projection is admittedly more pessimistic than the consensus, even the more optimistic forecasters anticipate that the current year will likely go on record as the worst in some 30 years. The high cost of mortgage financing is unquestionably the single most important reason for the debacle in the housing industry. Mortgage interest rates in California during mid-summer, 1982, ranged typically between 17 to 18 percent. Most housing industry analysts feel that mortgage rates would have to fall to at least 14 percent to begin recharging the industry's battery, and probably to 12 to 13 percent to get its motor going. Unfortunately, there is little likelihood that such a sharp decline (at least a sustained one) will occur within the near future.

There are a number of interesting questions to be answered regarding the future of the homebuilding industry in California. For example, assuming that the industry does experience a modest recovery in 1983, as Security Pacific Bank's projections anticipate, does the industry still have the capacity to build the number of homes that was considered "normal" during most of the 1970s, say in the neighborhood of 200 thousand units annually? There is mounting evidence that such a large number of builders and building industry suppliers have left the business, or have been so financially weakened, that an immediate return to high-volume production is not possible. Moreover, after the lambasting that many have taken in the past few years, it would seem assured that caution would prevail for quite some time in the future. That is not to say that the industry would never regain its prior strength. A prolonged period of strengthened profitability could be expected to lure former participants back into the industry and to encourage others to expand production.

Another important question regarding the home building industry's future is whether the "potential" demand for housing in the state is really as great as is often speculated. The results of the 1980 census shed some light on the issue. The number of housing units in existence in California increased from 7,000,174 in 1970 to 9,279,330 in 1980. That was a net increase of 2,279,156, or 32.6 percent. The increase in the State's total resident population during the decade was 3,697,493, or 18.5 percent. Therefore, the relative increase in the housing supply was much greater than the increase in population, and the average number of persons per housing unit has continued its long-term decline.

Although the relative increase in the housing supply was greater than the relative increase in population, two additional demographic trends also emerge from the 1980 census that could favor the argument that there does indeed exist a rising "potential demand" for housing in the state: (1) a large increase in the young adult population, and (2) a sharp rise in the total number of households. Reflecting the maturing of the generation born in the decade following World War II, the largest population gains during the 1970-80 period occurred in

CALIFORNIA CONSTRUCTION FORECAST

	1981A	1982F	1983F	Annual Growth Rates 1980-81	1981-82	1982-83
New Housing Permits (000)	104.9	78.1	101.5	-27.6	-25.6	30.0
Single Units	59.9	44.5	55.8	-30.8	-25.7	25.4
Multiple Units	45.0	33.6	45.7	-22.8	-25.3	36.0
Total Valuation ($ Millions)	16,331	14,404	16,824	- 1.4	-11.8	-16.8
Residential	7,509	5,737	7,648	-17.4	-23.6	33.3
Single Units	4,129	3,110	4,212	-22.6	-24.7	35.4
Multiple Units	2,149	1,481	2,175	-15.0	-31.1	46.9
Alterations	1,232	1,146	1,261	- 0.1	- 7.0	10.0
Nonresidential *	8,822	8,667	9,176	18.2	- 1.8	5.9
Commercial	3,958	4,433	4,344	20.9	12.0	- 2.0
Industrial	1,483	1,127	1,296	16.2	-24.0	15.0
Alterations	2,075	1,934	2,178	21.0	- 8.7	15.0
Other	1,306	1,213	1,358	8.8	- 7.1	12.0

A = Actual F = Forecast

*Note: Beginning with data for 1980, permits for nonresidential alterations and additions valued at $100,000 and over are no longer classified as new construction, resulting in lower totals for commercial, industrial, and other construction and higher totals for nonresidential alterations/additions. Consequently, only total nonresidential valuations are strictly comparable with past data.

the young-adult age groups. While the state's total population increased 18.5 percent, the number of people in the 25-34 age group was up 59 percent, and a 37 percent increase was registered in the 20-24 age group. In total, California's working age population — the prime market for homeowners or renters — reached nearly 14 million as of April, 1980 — 29.5 percent above the 1970 figure. The large increase in the young adult population, a high divorce rate, and trends toward more people living alone and couples having fewer children caused the total number of households in the state to increase 31 percent between 1970 and 1980 — nearly twice the rate of population growth. Consequently, the average number of persons per household fell from 3.0 in 1970 to below 2.7 in 1980.

To add currency to the above discussion, the estimated increase in the state's population from 1980 to 1983 is 1.2 million. Assuming 2.68 persons per household (the 1980 number), the number of households in the state could rise by 436 thousand for the years 1981-83, if household formations continue at the 1980 rate. As currently estimated, the number of new housing units that will be added to the 1980 stock during that period is 284.5 thousand — only two-thirds of the potential increase in the number of households. On the basis of these simple calculations, and disregarding a number of other potential influences, there is some reason to feel that there is a measure of "pent-up demand" for housing currently building in the state. One could bolster that argument by reducing the potential 1983 housing stock to allow for units taken out of the stock — often referred to as demolitions. A precise number of demolitions is hard to quantify, but it is generally believed to average around one percent of the existing housing stock each year, although it may be less presently. Using the historical one percent figure, the number of demolitions during the 1981-83 period would roughly equal the number of new housing units built, and the housing stock in 1983 would be essentially the same as in 1980, despite the estimated increase in the number of households.

Nonresidential Outlook

Nonresidential construction activity in the state, as measured by the valuation of building permits authorized, has tended to hold up better than has been the case for the residential sector, particularly through 1981. During 1982, however, the effects of substan-

tially weaker economic activity and high construction and long-term financing costs began to take their toll. After rising more than 18 percent in 1981, the valuation of authorized nonresidential construction for all of 1982 is expected to record a decline of nearly 2 percent from the previous year and is forecast to rise only 6 percent in 1983. Although commercial construction activity should show a 1982 gain, the categories of industrial construction, alterations and additions, and other nonresidential (such as churches and religious buildings, hospitals, etc.) have started a sharp descent. Not surprisingly, the recession both nationally and in California has led to a significant decline in capacity utilization for existing facilities and has also resulted in fewer new firms starting operations. When industrial facilities already have substantial unused capacity, they have little incentive to expand their facilities. Commercial construction activity, on-the-other-hand, did not react immediately to the general decline in business activity because in many cases financing commitments at better, prior rates had already been established or because the market appeared to be able to absorb higher square-footage rents, thus allowing the developer to recover added interest costs. Several metropolitan markets presently appear to be at or near the point of saturation for commercial space, however, which suggests that commercial building activity should be slowing markedly, or declining, in a number of areas — including San Francisco, Los Angeles, Orange, and San Diego counties. Many industry observers expect a significant slowing in rental rates, if not an actual decline, as vacancy rates begin rising in overbuilt areas. An added burden for commercial developers is the tremendous drop in residential building activity. Many projects, such as major shopping malls and neighborhood shopping centers, have been shelved because the residential base that was expected to support those developments has not materialized. Moreover, there is an emerging sentiment in several communities that additional facilities are either simply not needed, or that they would sufficiently congest the planned location so that they would detract from rather than add to the existing quality of the community.

Although the valuation of nonresidential building permits expected to be authorized during 1983 will be showing only modest improvement over 1982's level, industrial construction should begin to see the start of a relatively strong surge. Not only will the California economy be regaining strength following the 1982 recession, but the anticipated thrust of the national defense program should begin to be translated into the need for new or expanded industrial capacity. As mentioned in the earlier section on the aerospace industry, much of the proposed increase in Pentagon spending is expected to benefit California aerospace manufacturing firms. Secondary benefits should accrue to peripheral firms, multiplying the overall positive influence on the state's economy, and fostering an increase in building activity.

INTERNATIONAL TRADE*

Overview

The slowdown experienced by the state, national, and many foreign economies during 1981 severely limited the growth of California's international trade. Whereas growth rates of 15 percent and higher were the norm during the past six years, in 1981 both imports and exports increased only marginally to bring the state's total international trade to $61.7 billion. This year's international trade performance promises to be very much the same as in 1981 — sluggish or no growth in both the import and export sectors.

Low growth rates were not the only departure from the usual pattern followed by the state's international trade. The fact that both exports and imports slowed at the same time is also unusual. In the past, for example, whenever the domestic economy was in the process of recovering from a recession, many of the foreign economies with which the state trades would still be in their own recessions, resulting in much higher import growth rates for California than export growth. In the recession that began nationally in 1981, the domestic and foreign economic cycles have roughly coincided, with the consequences described under the three main topics covered by this article: imports, exports, and leading trading partners.

The slow recoveries expected for the economies of the state and its major trading partners in 1982, along with the continued strength of the dollar, should act to keep both import and export growth at a virtual standstill. In 1983, however, the state can look forward to more robust growth rates.

*It is important to note that the value of the goods exported and imported cannot be ascribed totally to California's economy, as the U.S. government records only the movements of commodities through the various ports and airports, not the points of origin or ultimate destinations. Thus, when "California's imports, exports, and trade balance" are mentioned, it should be borne in mind that the goods in question may not have been manufactured in the state or may ultimately end up in a state or country other than the original point of destination.

Exports

California's export growth rate in 1981 outpaced import growth for the fourth straight year, bringing the state's trade deficit to a six-year low of $1.7 billion. The value of exports rose 11.9 percent over 1980's level to reach $30 billion — a 2.4 percent real increase. (U.S. export prices went up 9.3 percent in 1981.) The most significant year-over-year gains in the value of the state's exports were posted by aircraft parts — up 25 percent; automatic data processing machines — up 27 percent; and grains — up 15 percent. The state's principal exports were non-military airplanes ($1.9 billion), cotton ($1.7 billion), and electronic components ($1.5 billion).

California's export growth was adversely affected by the continued strength of the dollar. Agricultural exports were especially hard-hit, increasing only six percent, and are expected to drop in 1982. Leading agricultural exports, besides cotton, are cereal grains, meats, and nuts and fruits.

Imports

California's merchandise imports in 1981 totaled $31.7 billion, a 7.7 percent increase over 1980's $29.4 billion. During the same time period, U.S. import prices increased 5.7 percent. Thus, assuming that California's import prices expanded at the same rate as the national average, imports grew only 1.9 percent in real terms. Cars, petroleum, and integrated circuits were the state's leading imports in 1981. These products are likely to continue to dominate California's import mix, notwithstanding the limitation on car imports and the dramatic drop registered by petroleum imports (30 percent in 1981).

For 1982, the state should see a slight acceleration in its import growth rates which will be spurred by the strong U.S. dollar and the beginnings of a domestic economic recovery. Electronic components and office machinery are the types of products most likely to register increases in 1982. The growth rate of California's imports should accelerate in 1983 as the state's economic recovery takes hold.

Leading Trading Partners

The origin and destination of California's international trade during 1981 did not vary much from its historical pattern. Asia continued to dominate California's international trade with a 69 percent share, with Europe a distant second at 16 percent. Asia was the destination for most of California's agricultural, textile, and aircraft exports and the origin for much of California's transportation equipment and consumer electronic goods (radios, TV's, cassette players, etc.) imports. The European region exported mainly transportation equipment, while receiving from California scientific instruments, aircraft and spacecraft parts, and computers and peripheral equipment.

Other significant California trading partners included Australia, Canada, and Mexico. Exports accounted for most of the California-Australian trade; largely metal products and transportation equipment. Trade with Canada was characterized by paper and paper board products destined for California, with metal products and laboratory instruments constituting a major portion of California's exports to Canada. California exports to Mexico rose dramatically in 1981 — 48 percent — fostered in part by the overvalued peso. The successive devaluations of the peso vis-a-vis the U.S. dollar in 1982 should help to make Mexico's exports more competitive on world markets as well as to limit its imports.

The ranking of California's major trading partners is expected to vary somewhat in 1982 from the 1981 lineup. The top slots, as has been the case in the past, will belong to Japan, South Korea, Taiwan, and Mexico. Singapore, however, is expected to move from the number eight position to the fifth spot, while Indonesia should drop out of the top ten — the first time since the OPEC oil crisis. West Germany, Hong Kong, the United Kingdom, and Malaysia should continue in approximately the same positions as in 1981.

CALIFORNIA'S LEADING TRADING PARTNERS 1981
(In $ Billion)

Country	Imports	Exports	Total Trade
Japan	12.4	7.0	19.4
South Korea	1.7	2.4	4.1
Taiwan	2.7	1.3	4.0
Mexico	1.0	2.4	3.4
Australia	.4	2.3	2.7
Indonesia	2.3	.4	2.7
Singapore	.8	1.8	2.6
West Germany	1.3	1.0	2.3
United Kingdom	.8	1.2	2.0

CALIFORNIA AGRICULTURE

Since California agriculture depends upon commodity markets impacted by weather and other production factors, the industry has not necessarily followed general business cycles. However, recent economic pressures have caught up with the agricultural industry in California in 1981 and 1982. Agriculture in California, as in the rest of the nation, has been plagued with weak market prices and high production costs, both being results of the downswing in the economy.

Gross receipts for California farmers and ranchers increased by a mere one percent in 1982 to $13.9 billion from $13.7 billion in 1981. This was caused by both sluggish market demand and high levels of production. Domestic and foreign buyers of California ag products were reluctant to buy since their respective markets were depressed and their cost of borrowed money for inventory was at record highs. In addition, the U.S. dollar was very strong, making California exports much more expensive for foreign markets.

One bright spot in 1981 for California agriculture was the slowing inflation of energy prices. Because of the increased availability of petroleum supplies, the cost of fuel, fertilizers, and water pumping grew by a mere fraction of the significant energy price increases of preceding years.

But the cost of production financing more than offset the relief in energy costs, resulting in a decline in net income for California ag in 1981. Unlike other industries, agriculture is extraordinarily impacted by swings in interest rates since crops or livestock production cannot easily be postponed until rates subside. While many growers were able to hold down their borrowings because of profits carried forward from preceding years, the high interest rates that slowed market demand also raised the overall cost of production, severely constraining profitability.

It is likely that there will be another drop in net income for California agriculture in 1982. As expected, interest rates have continued to be a problem for the industry in 1982. There has been hardly any change in financing costs for agricultural borrowers, and many growers have found it necessary to finance a greater portion of the production costs because of the smaller profits earned last year. In fact, some producers that were unable to repay all of the production loans for 1981 are paying interest for both that financing and their production financing for this year. While gross receipts may increase slightly from the lower level in 1981, the depressed economies domestically and worldwide are still making for soft markets. While there has been a slowing in the increase of nationwide production of commodities previously saturating the market, inventories of such surplus products have not been sufficiently depleted.

While the above is a summary of overall trends for California agriculture, the industry, in reality, is comprised of many segments each with their own respective markets and set of production circumstances. For example, in 1981, all field crops, cotton, alfalfa, grains, and sugar beets, were hard hit by poor market prices. On the other hand, grapes and lettuce enjoyed good prices partially resulting from reduced yields. Most of the fruits and nuts were faced with high productions and low prices. Like the fruit and nut commodities, livestock production in 1981 was depressed by weak market prices. The exception to this was the dairy industry benefiting from both price supports and cheaper feed costs.

In 1982, there has been only slight improvements in market prices. While field crops prices are still soft, cotton and alfalfa hay appear to be in for some improvement. Yet, there is a surplus in grain production, rice included. Because of poor growing conditions, processing tomato growers are enjoying good prices if they have a crop to sell. There has been more strength in prices for fruit and nuts this year with the surprises being the marked improvements for oranges and walnuts. However, the production of grapes is at much more normal levels causing the market to be unsettled, resulting in softer prices than last year's. Since livestock producers have reduced production, there has been an improvement in prices, a significant change from recent trends. The dairy producers are still enjoying good prices, but saturated markets and political attitudes suggest that there is a need for curtailment in production. Egg ranchers have had temporary boosts in market prices, but the industry stills faces an excessively large flock nationwide. Efforts are being made to reduce the level of egg production in hopes of attaining profitable prices.

An additional trend worth noting in California agriculture is the improved manner in handling the Mediterranean Fruitfly infestation. While the infestation was significant in 1981, it fortunately was primarily contained in urban areas or in agricultural areas after the

period of peak production. There were fears that the issue caused a softening of market prices, but the weak prices were primarily caused by saturated markets. However, California lemon growers lost a significant market during 1981 in Japan because of their quarantine. Much of California produce was harvested very quickly because of unseasonably hot weather in 1981. In 1982, it appears that the appropriate authorities have taken the necessary action to ultimately control the Mediterranean Fruitfly infestation.

While the California agricultural industry is currently depressed as a result of the recession, the long-term outlook is favorable. World populations are not only increasing, but their incomes are improving, enabling such consumers to better afford the products grown in California. Meanwhile, California agricultural land is good for many types of production, enjoys currently adequate water supplies, and can produce most of the year because of advantageous weather patterns. Such land is becoming more scarce. Therefore, California land values are expected to increase in the rest of the 80s as in the 70s even though average price trends have recently been flat.

TRAVEL AND TOURISM IN CALIFORNIA

In general, the tourism and travel-related industry in California appears to be withstanding the nationwide economic downturn reasonably well. Revenues statewide for 1981 were estimated at $28 billion according to the state Office of Tourism, a 12 percent gain from 1980. The state's five leading counties in tourism revenues are Los Angeles, San Francisco, San Mateo, San Diego, and Orange. Those five counties account for more than 70 percent of California's tourism revenues from domestic visitors.

Tourism is a broad based industry involving a variety of businesses in the services, retail trade, and transportation sectors of the economy. For example, a study of domestic travel expenditures prepared for the state Office of Tourism in 1980 indicated that over half of tourist and travel dollars were spent for transportation; about one fourth on food; 12 percent on entertainment, recreation, and incidentals; and 12.6 percent on lodging.

International visitor activity in the state is substantial and has been growing in recent years. However, it is likely that the number of foreign visitors declined slightly in 1981, partly due to the strengthening of the U.S. dollar (particularly against European currencies) and recessionary economic conditions worldwide. Visitors from Mexico constituted the largest group of international travelers to California — about 27 percent. The second largest group, Canadians, represented about 15 percent of foreign visitors. And, while the number of visitors from Mexico increased an estimated 9 percent in 1981, the state Office of Tourism indicates that visits from Canada decreased by 10 percent. Declines in travel from Canada and Europe were only partly offset by more visitors from the U.K., Australia, South America, and Mexico.

The state Office of Tourism projects revenues for California's travel and tourism industry in the range of $31 to $33 billion in 1982. That volume of business would result in an annual gain in inflation-adjusted terms of between four and seven percent. It should be remembered that much of the state's travel revenue is generated by California residents, and while slowdowns in out-of-state and international visitor activity may impact California, any declines in those sectors should be at least partly offset by increased spending by local residents. Visitor industry growth is likely to be inhibited by the recession throughout most of this year, although some improvement should be seen after midyear, following the federal tax cut. Continued marketing efforts regionally and statewide should help keep California competitive with other states for important tourism revenues.

TRENDS IN CALIFORNIA'S REGIONS

Although the recession has affected all areas of the state, the impact has varied somewhat among regions of California, reflecting differences in industry structure. The following articles discuss economic trends and the outlook for the state's three regions — Southern California, Northern Coastal California, and the Central and Mountain counties. The map on this page shows the geographical definitions of those areas.

☐ Pale Orange, Northern & Coastal Regions
▒ Grey, Central Regions
☐ White, Southern Regions

SOUTHERN CALIFORNIA

The nine Southern California counties as a group account for about 60 percent of California's population and total personal income and a similar share of most other measures of economic activity. And, while the Southland's economy is identified by some with a few well-known sectors — e.g. aerospace, tourism, and motion picture/television production — its industry mix is actually well diversified among a variety of goods — and service-producing activities. The relatively recession-resistant job sectors of services, trade, finance, insurance, and public utilities account for more than half of the region's nonfarm employment. And the aerospace-electronics group of industries contributes about one-third of the manufacturing jobs. Leading manufacturing industries (in terms of value of shipments) include petroleum refining, aircraft and parts, processed foods, communications equipment, electronic computing equipment, motor vehicles and parts, guided missiles and space vehicles and electronic components.

National Recession Weakens Regional Economy

Despite a balanced mix of industries and a manufacturing sector oriented toward high technology, Southern California's economy has clearly been adversely affected by the nationwide recession. The prevailing high interest rates have resulted in depressed sales of housing, autos, and other large ticket consumer items. Other industries experiencing considerable weakness include commerial aircraft, auto, and construction-related manufacturing, and industrial building. And, while expansion has continued for some of the region's industry groups, recent growth rates have been a fraction of what they were during the expansionary period of the late 1970s.

The overall impact of the recession is reflected in slowing employment growth and rising jobless rates. Data for the first five months of 1982 show a 0.3 percent year-to-year decline in the region's total wage and salary employment, with the greatest decreases recorded by contract construction and manufacturing. By comparison, growth in the region's total wage and salary employment averaged 1.7 percent in 1981, 1.5 percent in 1980, and an average of 5.5 percent per year over the 1975-79 period.

The halt in job growth and layoffs in some industries, combined with continued increases in the number of job seekers, caused the region's unemployment rate to rise throughout the first half of 1982. The Southland's unemployment rate averaged 8.4 percent during the first six months of 1982 — two percentage points above the year-earlier figure. However, 1981-82 labor market comparisons understate the weakness in some sectors. For example, in June, 1982, the region's construction employment was more than 15 percent below the year-end 1980 level. And in Los Angeles County's auto assembly sector, total employment in June of this year was down about 10,000 jobs — or 30 percent — from the peak of 29,000 reached in the first quarter of 1979.

Outlook: Gradual Recovery To Be Stimulated by Increased Consumer and Defense Spending

By 1983, Southern California's high technology and services-oriented industries should be recovering from the current slowdown. The long-awaited impact of higher defense expenditures should lead to 1983 job gains in the aerospace-electronics sector, following a job loss in 1982. Even though no resurgence in commercial aircraft manufacturing is expected during the forecast period, aerospace employment levels have already begun to reflect increased hiring for such new projects as the B1-B bomber and the Stealth bomber. Aerospace contractors in Southern California are involved in a variety of missile, aircraft, and space-related projects and account for more than 15 percent of DOD prime contract awards. While the government funding outlook is clouded for a number of specific projects, national defense expenditures should rise at least five percent per year in real terms over the next few years — a trend that will benefit Southland aerospace manufacturers substantially. But the continued weakness anticipated in commercial aircraft production will likely limit Southern California's aerospace-electronics employment gain in 1983 to about 12,000 jobs — only about half the average yearly increase during the 1977-80 aerospace expansion. Growth in the region's aerospace electronics employment should accelerate in 1984.

SELECTED ECONOMIC INDICATORS: SOUTHERN CALIFORNIA

	1975	1976	1977	1978	1979	1980	1981
Growth in Total Wage & Salary Employment (%) *	–0.7	3.9	5.7	7.4	5.1	1.5	1.7
Real Growth in Taxable Retail Sales (%) * *	–2.8	7.9	12.9	8.0	2.8	–5.2	1.8
Increase in Consumer Price Index (%)	10.6	6.6	6.9	7.3	10.8	15.7	9.8
Unemployment Rate (%) *	9.7	8.8	7.8	6.6	5.5	6.3	6.7
Annual Net In-Migration of Population (000)	133.4	122.1	148.6	158.7	148.8	158.6	132.0
Annual Housing Unit Authorizations (000)	67.0	122.9	153.4	134.9	111.9	77.0	59.2

*Based on data for Los Angeles, Orange, Riverside, San Bernardino, San Diego, Santa Barbara, and Ventura counties.
* *Adjusted for the "commodities less food" component of the Los Angeles - Orange County Consumer Price Index.

In total, the Southland's wage and salary employment is expected to increase about 1.5 percent next year — a modest gain compared with the first year rebound of 3.9 percent following the 1974-75 recession. Most of the region's 1982-83 job gains will take place in service-producing sectors, with the industry categories of services, retail trade, finance, and insurance setting the pace. Strong demand for health care and business services will lead to job gains. New employment prospects should also result from the pick-up in growth expected for the region's tourism activity. Travel by California residents has helped this industry to weather the recession, and as recovery gets underway, travel to Southern California from others parts of the U.S. and from foreign countries stands to increase.

Consumer spending in the Southland should experience modest growth over the forecast period, reflecting mixed trends. As a result of more moderate inflation rates, real household income gains are expected this year and next, compared with declines in 1980 and 1981. The outlook for retail spending is also helped by improved consumer balance sheets — resulting from the high debt levels assumed in the late 1970s being pared down — and from pent-up demand for automobiles and other durable goods.

But the continued high financing costs expected to prevail throughout next year will preclude a strong recovery for credit-sensitive items. Consumer purchasing patterns are also expected to be characterized by considerable caution and selectivity until there is stronger evidence that economic recovery has taken hold. The bank's index of department store sales for Southern California indicated no increase after adjustment for inflation during the first half of 1982. And recent auto sales figures show continued weakness for imported and domestic cars alike, with sales by used car dealers holding up somewhat better. The retail sales picture appears strongest for such sectors as eating and drinking places (reflecting continued population growth and rising tourism activity), auto supply stores (as many consumers repair their present cars rather than purchase new ones), and establishments selling electronic games and home computers.

High mortgage interest rates expected to persist through next year should cause the region's homebuilding activity to remain at historically low levels. The total of less than 45,000 new housing units expected to be authorized for construction in 1982 should increase to about 55,000 next year. Those figures compare with 1980 and 1981 totals of 59,000 and 77,000, respectively, and a yearly average of 130,000 during the 1976-79 period. Adding to the impact of low levels of homebuilding activity on the region's construction employment is the prospect of lower levels of nonresidential building. In the months ahead, many of the large office buildings begun in Los Angeles, Orange, and San Diego counties in the last few years will be completed. Office building in 1983 should be below the unusually high 1980-82 pace, as absorption of the newly completed space will take several years. In recent months, construction has begun for a number of

new hotels, and a major expansion project is underway at Los Angeles International Airport. On the other hand, industrial building activity will likely remain at low levels over the next few months, with an upturn probable in 1983 as the expected increase in aerospace manufacturing activity necessitates additional plant capacity.

During the balance of this year, the Southland's overall economic outlook will — to a significant extent — mirror the weak expansion anticipated for the nation. But by late 1983, the region's high technology manufacturing-and service-oriented industry mix and the area's attractiveness to new residents should enable expansion at rates above those expected for the nation as a whole. On the other hand, the Southland's jobless rates will come down slowly, and activity in the housing-related and auto assembly industries will probably remain at relatively low levels during the next several years.

CALIFORNIA'S CENTRAL AND MOUNTAIN COUNTIES

Although most business indicators have shown that the economy of California's Central and Mountain counties has responded to current recessionary pressures about 2-to-3 months after the state as a whole, the magnitude of the region's business downturn has been severe and has cut across many economic sectors. Unlike the 1974-75 recession when Central California's stable agricultural base helped to insulate the local economy from the nationwide economic downturn, the current recession has slowed activity in numerous industries including agriculture, manufacturing, wholesale and retail trade, and particularly in construction.

After expanding at a 4.0 percent average annual rate from 1975 through 1980, growth in total wage and salary employment in Central California's seven major metropolitan counties* slowed to 1.9 percent in 1981. And during the first half of 1982, total wage and salary employment dropped, averaging a 0.2 percent year-over-year decline.

Unemployment rates in the region suggest a considerably weaker employment picture in 1981 and 1982 than was the experience of the 1974-75 recession. Averaging a seasonally-adjusted 12.5 percent from January to June, 1982, unemployment rates climbed by 2.8 percentage points over the year-earlier period. That substantial rise in the jobless rate compared with a 2.4 percentage point increase for the state and was double the gain in Central California's unemployment rate during the 1974-75 downturn. While unemployment rates in California's Central and Mountain counties have traditionally been higher than in other areas of the state, because of the seasonality of the large farming and food processing sectors, the rapid rise in rates this year compared with previous years is more directly related to the region's sluggish economy — the number of new jobs created in the labor market grew less than one percent in the first half of 1982, while the number of job seekers advanced 4.2 percent. While unemployment rates in the second half of 1982 are likely to follow normal seasonal patterns, declining substantially during the fall harvest season and rising again during the winter months, the region's seasonally-adjusted jobless rate for all of 1982 will probably average 12.0-12.5 percent — compared with the 10.3 percent figure in the recession year of 1975.

Retailing in Central California has also experienced widespread weakness. After recording a meager 6.3 percent nominal increase in 1981, taxable retail sales in Central California showed almost no growth at all in early 1982. The healthiest retailing sectors have been eating and drinking establishments and apparel and general merchandise stores. Also auto sales in Kern and Sacramento counties have registered modest year-over-year growth, offsetting weaker trends in most other Central California counties. Sales of auto supplies have also shown gains, as consumers spend more on auto repair as an alternative to new car purchases. But, led by sharp reductions in spending for farm implements, lumber and building materials, home furnishings, and gasoline, taxable retail store sales in Central California's seven major metropolitan counties reported no year-to-year growth during the first quarter of 1982, and it is likely that second quarter sales showed little or no improvement.

Similar to the state as a whole, Central California's service industries are the brightest spot in the local economy. Population in the 33 Central and Mountain counties advanced 2.7 percent annually in 1981. This continued growth has spurred the need for increased personal and business services, especially health care.

*Fresno, Kern, Placer, Sacramento, San Joaquin, Stanislaus and Yolo counties.

Moreover, the tendency of consumers to postpone purchases of "big-ticket" items such as autos and appliances has resulted in increased business activity for repair services. Services employment in Central California's seven major metropolitan counties rose about 1 percent annually in the first half of 1982. That positive growth trend should continue as the year progresses, helped partly by the region's tourist trade.

High interest rates, restrictive monetary policies, and overall uncertainty about current economic conditions have dealt a severe blow to construction activity in the state's Central and Mountain counties. With the exception of the Sacramento area, where commercial building permit valuations remained 46.4 percent above the year-earlier period in the first six months of 1982, all other nonresidential and residential construction sectors registered substantial year-to-year declines. For instance, with only 9,326 dwelling units authorized for construction in California's 33-county Central and Mountain region in the first six months of 1982, residential building was 35 percent below the already depressed year-earlier total.

Closely linked to the nationwide slowdown in building activity is the depressed condition of lumbering — an industry sector that plays a major role in many of the state's mountain counties. In the lumber and wood products category of manufacturing, employee payrolls dropped about nine percent statewide from mid 1981 to mid 1982. Most of the jobs in that employment group are centered in California's mountain counties, and cut-backs and shut-downs in lumber milling facilities will continue to affect the economy of that region at least through 1982. Activity in the region's lumber industry is currently hurt by reduced demand for lumber products and a need for more modern capital facilities. When recovery begins in the construction sector — a trend which is not likely to occur until 1983 — lumbering is expected to expand as timber operations and mills increase production to meet a pent-up demand for lumber.

The state's petroleum industry, centered primarily in the San Joaquin Valley, is an important source of income for the Central California economy. However, after experiencing a record oil drilling year in 1981, drilling activity dropped by about 20 percent annually in the first half of 1982. The region's petroleum production during the first five months of the year was 4.3 percent above the year-earlier level, compared with an 11.1 percent rise for the similar 1980-to-1981 period. Lower oil prices and weakened demand for petroleum products will probably continue to curtail production in the coming months, although the recent discovery of "light" oil, which is less costly to pump and refine, may improve prospects for the San Joaquin Valley petroleum industry over the longer term.

The Central Valley accounts for about two-thirds of California's agricultural revenues. The region's farm sector exhibited some weakness through the first half of 1982, with the lower prices and reduced demand for

SELECTED ECONOMIC INDICATORS:
33 CENTRAL AND MOUNTAIN COUNTIES OF CALIFORNIA

	1975	1976	1977	1978	1979	1980	1981
Growth in Total Wage & Salary Employment (%) *	3.3	3.8	4.1	5.9	4.7	2.0	1.9
Real Growth in Taxable Retail Sales (%) * *	0.2	8.0	11.2	9.1	3.2	–8.2	0.2
Total Gross Farm Revenue (In $ Millions) * * *	5,401.2	5,758.9	5,945.7	6,281.7	8,651.3	9,679.0	9,122.5
Unemployment Rate (%) *	10.3	10.1	9.8	9.1	8.4	9.1	9.8
Annual Net In-Migration of Population (000)	56.8	73.5	83.3	83.6	80.7	75.6	72.8
Annual Housing Unit Authorizations (000)	34.0	53.5	63.6	62.6	58.3	35.3	25.4

*Based on data for Fresno, Kern, Placer, Sacramento, San Joaquin, Stanislaus, and Yolo counties.
* *Adjusted for the "commodities less food" component of the Consumer Price Index.
* * *Includes Central California's 26 major farm counties.

many commodities leading to slower growth, it is anticipated that farm commodity prices will show modest improvement as the year progresses, but high financing and operating costs will curb farm expansion and farm supply and equipment purchases for the remainder of the year. Nonetheless, as the region's leading basic industry, it is anticipated that agriculture will continue to provide a stable base for the local economy.

Central California's manufacturing sector reported a weak first-half performance in 1982 with durable goods manufacturing generally more sluggish than the nondurable goods group. One exception to the downturn in the durable goods sector was the Sacramento area where payrolls actually expanded by 2.7 percent annually in June. It is likely that that area benefited from the build-up in electronics-related manufacturing activity which has occurred in recent years. Elsewhere in the region, durable goods manufacturers have generally reduced production to match sales in an effort to keep inventory levels down.

Nondurable goods manufacturing, which in Central California consists primarily of food processing activities, has also shown some slowing, with payrolls declining 2.6 percent annually in the first half of 1982. That contraction, however, was not as severe as the 5 percent annual decline in durable goods payrolls, and moderate job growth is expected in food processing during the peak-production fall season. Lower yields for processed food commodities could, however, dampen prospects for a strong increase in production at food processing plants.

In total, the outlook for a rebound in Central California's business activity is unlikely through the remainder of 1982. However, continued expansion of high-technology firms in the region, the development of new foreign and domestic markets for California's agricultural products, the expected upturn in demand for lumber and wood products, and an improvement in the supply and demand picture in the petroleum industry all speak well for strong economic growth in Central California over the longer term.

NORTHERN COASTAL CALIFORNIA

Overview of Recent Trends

The painful effects of the nationwide recession were clearly visible in Northern Coastal California's business barometers during the first half of 1982. Homebuilding, housing sales, and lumber industry activity continued to weaken during the earlier months of the year, as an anxiously-awaited improvement in financial conditions failed to occur. Construction of nonresidential properties also experienced a modest retrenchment, after a solid 1981.

In the labor market, new job growth in the San Francisco Bay Area nearly came to a halt and the unemployment rate nudged upwards as the first half of the year progressed. Despite the rise in the number of unemployed, the Bay Area's unemployment rate remained well below that of the state. And the fact that employment showed even modest gains attests to the area's economic resiliency, which stems in large part from a diverse industry mix, high-tech manufacturing base, and minimal reliance on heavy industry. A far more discouraging first half 1982 labor market picture emerged in those Northern Coastal areas dependent on the depressed lumber industry.

Retail markets in Northern Coastal California were generally subdued during the first half of the year, though showing hopeful signs by late spring. One bright spot in the region's economy during early 1982 was the swift and sizable reduction in inflation.

Outlook through 1983 — Moderate Improvement on the Horizon

It is likely that economic conditions in Northern Coastal California will improve in the second half of 1982, and that the progress will carry into next year. During this period, the local economy is expected to benefit from a number of favorable developments, including inventory restocking; a lower inflation rate, which has led to modest real income gains; and the mid-year tax cuts and higher social security payments. Additional impetus to the local economy should stem from the strength in the markets for consumer electronic products and personal computers. While the drop in interest rates in mid summer was very much welcomed, the anticipated recovery along with budget deficits and a restrictive monetary policy will likely keep the cost of credit at a level that will limit the economy's forward momentum.

SELECTED ECONOMIC INDICATORS: NORTHERN COASTAL CALIFORNIA

	1975	1976	1977	1978	1979	1980	1981
Growth in Nonagricultural Employment (%)	0.6	3.7	4.7	6.0	4.8	3.5	1.6
Real Growth in Taxable Retail Sales (%) *	–0.6	9.1	11.8	3.4	4.4	–3.5	–3.3
Annual Increase in Consumer Price Index (%)	10.2	5.6	7.6	9.2	8.8	15.1	12.9
Unemployment Rate (%)	9.2	8.7	7.5	6.3	5.7	5.8	6.4
Annual Net In-Migration of Population (000)	43.6	46.5	41.5	31.3	32.6	25.4	4.0
Annual Housing Unit Authorizations (000)	30.8	45.5	53.7	46.3	39.9	32.5	20.4

*Adjusted for inflation with the "commodities less food" component of the San Francisco - Oakland area Consumer Price Index.

The Bay Area's high-tech sector, which forms the backbone of Northern Coastal California's manufacturing industry, has not escaped the adverse influences associated with the nationwide recession. The local high-tech sector has managed to weather the economic storm better than in past recessions. But in the last two years the industry has had to contend with softening markets at home and abroad, keen price competition from Japanese imports in some product lines (e.g., the 64K random access memory chip), and a rising value of the dollar vis-a-vis other currencies. There have been a few exceptions to that general pattern. Video games and personal computers, for instance, are two electronic products that have set sales records despite poor economic conditions.

Markets for electronic products should strengthen in the second half of 1982 and in 1983 in response to the anticipated nationwide recovery, the defense build-up, and the introduction of new products. Market growth of electronic products will be tempered, however, by the weakness in capital expenditures, as business proceeds to conserve cash and rebuild their balance sheets. The high value of the dollar on foreign exchange markets also can be expected to discourage sales abroad. On balance, 1983 should be a better year than 1982 for the high-tech sector, with the consumer, communication, and defense segments of the electronics market doing the best.

Job prospects in the San Francisco Bay Area were dim during the first half of 1982 but better than in the balance of the state. At midyear, employment in the Bay Area was practically unchanged from the year-ago level. The entire state, however, experienced an actual loss in wage and salary jobs during the twelve month period ending June 1982. With job growth coming nearly to a halt, the unemployment rate for the Bay Area trended higher during the first six months of this year, registering a non-seasonally adjusted 7.7 percent in June, 1982 compared with 5.8 percent one year earlier. Employment growth is likely to show improvement through 1983, following in the footsteps of the nationwide recovery. A quick turnaround in the job picture is unlikely, however, due to the restricted character of the business upswing. The brightest employment prospects should be in health care, business services, consumer products industries, and defense-associated industries. For all of 1982, wage and salary employment should show an increase of about 0.5 percent over 1981, which translates into 12,000-13,000 new jobs. The unemployment rate should average around eight percent — a figure significantly lower than that anticipated for the state and the nation. Employment growth should accelerate in 1983 to around 1.5 percent while the Bay Area's unemployment rate heads slowly towards an annual average of 8.2 percent.

Northern Coastal California's retail markets demonstrated little strength during the first half of 1982. In the first quarter, retail sales were up by a meager 2.7 percent over the like 1981 period — a decline in constant dollar terms. Another sign of weakness was the widespread use of price discounts and other incentive programs to move items off shelves. Auto sales were slow and spotty, registering some improvement during promotions but showing few signs of a vigorous or long lasting upturn. Expenditures for household furnishings and appliances also were disappointing, due in part to the slump in housing sales and homebuilding. The second half of 1982 and next year look more promising for the region's retailers. Having reduced their debt burdens and reliquified their balance sheets in the past several years, consumers are in reasonably good financial shape. That factor, combined with the mid-year tax cut, disinflation, and the growing replacement demand for durables should act to loosen the consumer's purse strings some. But the continued high financing costs that are anticipated through next year will limit sales growth for credit-sensitive items.

Homebuilding activity and home sales remained at depressed levels during the first half of 1982, with the downward phase of the housing cycle not yet arrested. Inventories of unsold homes persisted at undesirably high levels. Real estate transactions in Northern Coastal California took another tumble in the first quarter of 1982 — some of the reduction, no doubt, related to the weather. As indicated by permit authorizations, during the first six months of the year, home construction was at an annualized rate of 16,300 units — down one third from the first half, 1982 already-low level. To some degree, that reduction can be explained by last winter's severe weather, and some seasonal improvement should occur during the second and third quarters. But a sustained and buoyant reversal in the housing market is unlikely to emerge in 1982 as that would require much lower mortgage rates than are likely to be seen. A second-half upswing in business activity could diminish some of the economic uncertainty and improve consumer confidence — hence removing one important obstacle to a housing recovery. Nonetheless, the industry is not likely to surpass last year's grim performance. For all of 1982, housing permit authorizations may number around 17,000, down from the prior year's 20,000 total. The volume of real estate sales, too, could experience another appreciable drop in 1982. While difficult to verify with reliable data, market conditions strongly suggest that home values have stopped advancing — a condition not likely to change significantly in the balance of this year. 1983 should be a year of modest recovery for Northern Coastal California's housing markets, with homebuilding moving up to the 20,000 level. But the fact that housing activity will remain low by historical standards will limit the recovery in the region's lumber industry. ■

UNITED STATES NEAR-TERM OUTLOOK

The summer of 1982 has passed with no conclusive evidence that the economy has begun to recover. Although interest rates eased during July and August and the tax cut gave a substantial boost to disposable personal income in the third quarter, consumer spending patterns remain markedly cautious. The reserve shown by retail spending behavior, which is considered to be related importantly to the adverse unemployment trend in the third quarter, has been accompanied by moribund capital spending that has resulted in a generally sluggish economy. Although consumer spending and inventory rebuilding should place the economy on a positive growth trend during the second half of 1982, the recovery will lack the accelerating force that would be imparted by a more normal, historical pickup in business capital spending.

The current forecast recognizes a very high level of uncertainty about the sustainability of the economic recovery that now appears to be imminent. That uncertainty is a product of the current economic policy environment in which a relatively tight monetary policy is countered by fiscal stimulus and very high deficits that generate continued strong demand for money. This forecast assumes that the additional 10 percent personal income tax cut scheduled for July of 1983 will be implemented substantially as written, contributing to a sizable federal budget deficit for fiscal 1983. Although it now appears likely that the personal income tax cut will be offset to some extent by new levies on other income sources, the net effects of these measures, in our view, will be greater-than-anticipated shortfall in revenues due to the weakness of the economic recovery, producing a budget deficit in the range of $140-150 billion.

Interest rates should also remain quite volatile in the 1983 environment, sufficiently unstable that a miscalculation on either the fiscal or monetary side of policy could push interest rates high enough to cut the recovery short. This delicate balance that we face through next year is posed by the difficulty of financing a sustained private sector expansion at a high level of interest rates and in competition with record federal financing requirements. Although it is implicitly assumed that sufficient credit will be available to fund the needs of an economy that is expanding at a nominal growth rate of 9-to-10 percent in 1983, that expansion could be very uneven in view of current estimates of the budget deficit.

The tax cut is viewed as a sustaining, rather than stimulative, force for consumer spending during the remainder of 1982. The relatively large increase in disposable incomes as a result of the tax cut should offset the negative effects of lingering high unemployment and relatively tight consumer credit on retail spending. The reduction in inflation should help to boost real purchasing power, especially in 1983. Although auto sales are expected to improve to an average of 9.4 million units in 1983, credit buying should continue to show restraint, and retail spending generally is likely to be related more closely to income gains in the 1983 economy.

The housing sector has been one of the most troubled areas of the 1982 economy, and has thus far shown no ability to sustain production much above an annual rate of 1 million units. Not too long ago, 2 million housing starts per year were regarded as normal. Although there is evidence of some over-production of housing during the inflationary boom of the late 1970s, the current plight of the industry is more closely related to the poor financing terms that have recently prevailed than to speculative overbuilding.

Although housing activity should pick up gradually in late 1982, total housing starts will probably not exceed 1.3 million on a sustained basis until late 1983. Since mortgage rates are expected to remain consistently high for at least the remainder of 1982, the affordability of new homes will continue to be a problem for a large proportion of potential homebuyers. As employment stabilizes and disposable incomes increase during late 1982 and 1983, mortgage rates should be less of a constraint on new home sales than they have been during the past year. Similar to the situation in the auto industry, the housing sector is currently believed to be facing a large backlog of deferred purchases that should lead to an improved outlook for housing, especially during years beyond 1983.

FORECAST HIGHLIGHTS
1981-1983
(Billions)

	1981A	1982F	1983F
Gross National Product	2937.7	3086.2	3378.8
% Change	11.6	5.1	9.5
Real GNP (1972 $)	1502.6	1480.8	1522.1
% Change	1.9	–1.5	2.8
GNP Deflator (1972 = 100)	195.5	208.4	222.0
% Change	9.4	6.6	6.5

A = Actual F = Forecast

Business spending for new plant and equipment has been depressed by a combination of high interest rates, excess capacity, and poor profitability, and the recovery in this sector is expected to lag the rest of the economy by about six months. Investors will have to see evidence of a recovery in product markets before they will undertake major new expenditure projects, and some combination of lower long-term interest rates and improved corporate cash flow will have to occur in order to finance those projects. Inventory rebuilding should begin sometime during the fall of 1982 and gain strength steadily throughout 1983, although a continuing high level of uncertainty combined with the anticipated high levels of real interest rates should discourage rapid inventory accumulation.

The good news during 1982 has been the break in inflation that actually saw brief declines in both consumer and producer prices during the early part of the year. Although the early relief in inflation was wiped out by a midyear bulge that was primarily related to a turnaround in basic energy costs, the inflation rate should be returning to a range of 6 to 7 percent for the remainder of 1982 and 1983. This forecast is based on an assumption that demand pressures on prices will continue to be very weak through 1983. Capacity utilization in the economy recently dipped below 70 percent, and is expected to increase very gradually from current levels as the economy recovers. In broader terms, the economy is expected to continue operating far below its potential capacity well into 1983, and that slack should prevent more than a gradual increase in inflationary pressures. Cost pressures on prices also appear to be moderating, although specific items such as natural gas and electricity will probably increase rapidly in cost through 1983. The most significant change in the cost structure of the economy, however, has occurred in the area of labor costs, which now appear to be increasing much more gradually than in 1980 and 1981.

MONETARY POLICY & FINANCIAL MARKETS

Since the Federal Reserve changed its operating procedures in October 1979, there has been little question about its resolve to slow inflation. For those who had lingering doubts, most of them likely became believers in 1982. After all, it has been when the economy was in recession that monetary policy has usually erred on the side of excessive ease and caused a renewed burst of inflation. This time, however, despite widespread business bankruptcies and concern about the economy's ability to begin a sustained recovery, the Federal Reserve has stuck to its policy of restraining 1982 M-1 growth to the 2.5 to 5.5 percent range. (M-1 is composed of currency, demand deposits, all other checkable deposits and travelers' checks.)

In virtually the entire first half of 1982, money supply growth was above the Federal Reserve's target. Only in the last weeks of June did the combined effects of a weak economy and restrained monetary policy finally bring M-1 growth within its target range and allow the Federal Reserve to begin providing more reserves to the banking system and to lower the discount rate. The Federal Reserve's performance was clearly a study in patience, but early 1982 was also a frustrating period for members of its policy-making arm (the FOMC or Federal Open Market Committee) because interest rates refused to fall in the face of a sharp decline in the rate of inflation. Real (inflation-adjusted) interest rates thus stood at their highest levels since World War II, imposing a significant hardship on the economy.

A fundamental factor troubling financial markets in 1982 has been the size of current and prospective Treasury budget deficits. Fears that huge and growing deficits will ultimately force the Federal Reserve to pursue a more inflationary policy kept financial markets in the doldrums and interest rates high. Significant strides were made in slicing government spending programs and enhancing revenues, but market participants realize that much remains to be done. Otherwise, once the economic recovery takes firm hold, "crowding out" of private credit demands by government needs may become a reality.

Credit market turmoil during the early months of 1982 was caused not only because the Treasury was absorbing an ever-larger amount of credit market funds but also because short-term business credit needs continued to mount. Unlike 1975 when short-term business credit demands subsided along with inventory liquidation, businesses continued to borrow in 1982 despite reduced inventory levels. One prominent reason for this result was the very illiquid state of businesses. A sharp deterioration in business profits occurred this year. Furthermore, businesses were unable to follow the traditional pattern of restructuring their debt from short-term to longer-term because of hostile long-term markets. Thus, short-term debt has been substituted for long-term. Another reason for strong short-term borrowing is that credit needs have apparently been enhanced by decisions to pay extra corporate taxes in order to avoid possible payment of the new higher-penalty rate of 20 percent imposed by the IRS.

Whatever the reasons, commercial and industrial loans by banks exhibited rapid growth during 1982's first half, up approximately 20 percent at an annual rate. Moreover, loan growth was stronger than commercial paper growth, relative to recent years, no doubt in part because the precarious financial state of many businesses precluded them from obtaining funds through the commercial paper market.

Other major types of borrowing — most importantly, consumer, mortgage, and corporate bond issuance — have remained weak through this period of high rates. Thus, overall credit demands in 1982 will be recorded as modest, despite large Treasury borrowing and first-half strength in short-term business borrowing.

Outlook for Policy and Interest Rates

In the second half of 1982 and throughout 1983, monetary policy-makers are anticipated to stick to their basic course of slowly reducing the growth of the money supply. Due to concern about being overly restrictive, the Federal Reserve announced in July, 1982, that it would be satisfied with M1 growth at or slightly above target at year-end, 1982, and that it would retain the same target levels for 1983 (instead of reducing them by half a percentage point). This policy announcement makes a sustainable economic recovery possible and, indeed, likely. Without this sort of flexibility, an aborted recovery would be much more likely.

In 1983, even though the economy will likely be in a weak but sustained recovery, interest rates should move lower on average than in 1982. The reasons for this expectation are that real interest rates were at record levels for the postwar period in 1982 and that inflation is anticipated to stabilize near 6 percent in 1983. In this type of an environment it seems natural that real interest rates, as well as nominal rates, will ratchet downward toward the level of inflation.

Thus, in the year ahead, the overall effect of Federal Reserve actions and the economy on interest rates will most likely be that their average will decline by a percentage point or two, though market rates will likely rise from their lows in the summer and fall of 1982. For example, the prime rate is expected to average approximately 13.5 percent during 1983 compared with close to 15 percent in 1982, and seasoned high-grade corporate bonds are likely to move from an average of 14.5 percent in 1982 to less than 13 percent in 1983. It is important to remember, however, that even with these declines, interest rates will remain very high by historical standards. Lastly, in this interest rate environment, private credit demands over the course of 1983 will likely remain moderate for this stage of the business cycle.

GOVERNMENT SPENDING

The Federal government's fiscal policy for the 1983 fiscal year has been a topic of greater than normal concern and speculation. A comparison of projected federal budget estimates with those of recent years reveals three salient features: substantial reductions in the growth rates of both receipts and outlays and a significant increase in the level of the budget deficit. The tax reductions approved in the Economic Recovery Tax Act of 1981 and the severity and length of the current recession have combined to increase the uncertainty and concern regarding the size of the 1983 budget deficit.

The effect of a weakening economy on the budget deficit is clearly shown in the accompanying table, which compares the various budget estimates that have been prepared over the past two years. The underlying economic assumptions for the calendar year are also shown. The Administration's 1983 Budget sent to Congress in February projected a 4.5 percent increase in outlays, a 6.3 percent increase in receipts, and a unified budget deficit of $91.5 billion. Those budget estimates included the enactment of a number of spending and revenue measures totaling $56 billion. These estimates were substantially different from those prepared by the Administration in March, 1981 for the 1983 fiscal year. A changed economic environment had reduced projected receipts by $53 billion and increased projected

FISCAL YEAR 1983: A WIDENING DEFICIT

Unified Budget Deficit ($ Billions)	Administration Budget — Feb. '82	First Budget Resolution — May '82	Administration Midyear Review — July '82	SPNB
Receipts	$666	$677	$647	$628
Outlays	758	781	762	770
Deficit	92	104	115	142
Economic Assumptions: Calendar Year				
Real Growth	5.2%	4.4%	4.4%	2.8%
Inflation	6.3%	7.5%	6.8%	6.5%
Unemployment Rate	7.9%	8.0%	8.4%	8.8%
Treasury Bill Rate (90 Day)	10.5%	13.2%	10.7%	9.5%

outlays by some $37 billion. The Administration's budget estimates were almost immediately criticized as being overly optimistic with respect to both the underlying economic assumptions and the sensitivity of the budget estimates to those forecasts. Accordingly, the First Budget Resolution, passed by Congress in May and required by the Congressional Budget and Impoundment Control Act of 1974, was based upon a less optimistic set of economic assumptions prepared by the Congressional Budget Office. The resolution estimates, however, did reflect additional, but unspecified, revenue measures of $32 billion, and spending cuts of $46 billion from the CBO's current services estimates. In July, the Administration presented its midyear budget review which reflected further economic weakness and a widening deficit.

According to the economic projections of this report, the Administration's midyear estimates would still appear overly optimistic. Substantially slower real growth and a somewhat higher level of unemployment should continue to reduce receipts and to increase outlays, raising the deficit to over $140 billion. The estimate includes the effects of the passage of the compromise tax bill and of the individual tax rate reduction scheduled for July 1, 1983. On the National Income and Product Account basis, federal purchases of goods and services are projected to increase at a slower rate than the overall economy, with real purchases rising 0.7 percent in calendar 1983. Although defense outlays are expected to grow at an inflation-adjusted rate of approximately 7 percent, nondefense purchases are expected to decline in both nominal and real terms. Reflecting weak economic growth and approximately a 7 percent increase in prices, transfer payments are expected to rise over 9 percent. In contrast, federal grants to state and local governments are expected to decline almost 20 percent from the 1982 level.

Although a recovering economy will generate increased receipts, state and local governments are expected to experience continued fiscal pressures. In addition to the drop in federal grants, economic uncertainty and a sluggish recovery will encourage the sector to restrain the growth of controllable outlays. Overall, state and local purchases are projected to grow 5.4 percent in 1983, following a 6.0 percent increase in 1982; however, after accounting for price increases, state and local purchases should register a 1.5 percent decline in1983, following declines of 0.8 percent and 1.2 percent in 1981 and 1982, respectively.

CONSUMER SPENDING

A review of the recent behavior of consumer spending for most categories of goods and services shows strength that is surprising in view of the weakness of total output since mid-1981. Total personal consumption expenditures increased 2.4 percent and 3.1 percent, respectively, during the first two quarters of 1982, following a 3.3 percent decline in the fourth quarter of 1981. Most of the recent news regarding consumer spending has tended to focus on the automotive sector of durable goods, which has been a generally poor performer since the end of 1979. Consumer spending for cars, especially new vehicles, has tended to fluctuate widely in response to the existence or absence of special promotional programs that effectively lower the cost of purchasing an auto. Total passenger car sales

dropped from 10.6 million in 1979 to only 8.6 million in 1981, and averaged only 7.8 million units during the first half of 1982. Consumer spending for furniture and household equipment, which declined steadily from early 1981 through the first quarter of 1982, largely reflecting the weakness of the real estate market during that period, began to revive during the second quarter of 1982. Other durable goods — a category that includes a wide variety of industries ranging from lumber and wood products to electronic equipment, performed strongly during the first half of 1982, showing a real growth rate of about 6 percent during that period. Consumer spending for nondurable goods and services, which far outweigh the durable goods category in total dollar terms, have generally held up better than durable goods spending during the recession. That difference is due partly to the fact that purchases of durable goods, such as automobiles and furniture, are more easily postponed than are purchases of food and medical services, for which needs are often acute. Although nondurable goods purchases declined modestly in early 1982, due mainly to a drop in real spending for food, the second quarter saw real growth of almost 4 percent in nondurable goods expenditures. Real spending for clothing and shoes increased more than 4 percent in the first half. In the service category, total spending rose at about a 3.4 percent annual rate in the first half of 1982, and was led by transportation services, which gained 8.4 percent; other services, up 2.7 percent; and housing services, up 2.1 percent.

In this forecast, the tax cut is viewed as a sustaining, rather than stimulative, force for consumer spending during the remainder of 1982. Real disposable income probably increased at an annual rate of at least 7 percent in the third quarter, in spite of a temporary rise in inflation. The effect of the income gain on retail spending, however, may be blunted by the high level of unemployment and the continuing unease in credit markets. Sales of automobiles, in particular, have been very sensitive to credit conditions, and only a very gradual improvement in consumer financing terms is foreseen in this forecast. After reaching a dismal average of only 4.6 million units during June, domestic auto sales have picked up somewhat, but probably will not reach much above the 6 million level until the fourth

ECONOMIC OUTLOOK

Selected Economic Indicators

	1982				1983				Annual		
Item	IA	IIP	IIIF	IVF	IF	IIF	IIIF	IVF	81A	82F	83F
Housing Starts (Millions)	0.92	0.96	1.10	1.30	1.20	1.20	1.30	1.40	1.10	1.07	1.28
Automobile Sales (Millions)	8.2	7.4	7.9	9.0	8.8	9.1	9.6	10.0	8.6	8.1	9.4
Unemployment Rate (percent)	8.8	9.5	9.8	9.5	9.3	9.1	8.9	8.7	7.6	9.4	9.0
Industrial Production (1967 = 100)	141.8	139.3	139.6	141.9	143.6	146.7	150.6	153.4	150.9	140.6	148.6
% Change*	–11.7	– 6.7	1.0	6.5	5.0	9.0	11.0	7.5	2.6	–6.8	5.6
Personal Income ($ Billions)	2510.4	2549.5	2611.0	2670.9	2725.9	2778.9	2849.1	2919.1	2415.8	2585.4	2818.2
% Change*	2.6	6.4	10.0	9.5	8.5	8.0	10.5	10.2	11.8	7.0	9.0
Disposable Personal Income ($ Billions)	2117.1	2151.9	2233.7	2280.4	2321.4	2356.2	2441.7	2495.8	2029.1	2195.8	2403.8
% Change*	3.0	6.7	16.1	8.6	7.4	6.1	15.3	9.2	11.2	8.2	9.5
Corporate Profits Before Taxes ($ Billions)	171.6	168.7	182.7	195.8	207.9	222.2	234.2	249.5	232.1	178.8	228.4
% Change*	–60.5	–6.6	37.6	31.9	27.1	30.5	23.4	28.8	– 4.3	–22.9	27.7
Consumer Price Index (1967 = 100)	283.6	286.8	293.7	298.0	302.5	306.4	310.8	315.5	272.4	290.5	308.8
% Change*	3.2	4.6	10.0	6.0	6.2	5.3	5.8	6.2	10.4	6.6	6.3
Producer Price Index (1967 = 100)	277.2	277.7	284.0	289.1	292.9	296.4	300.4	304.9	269.8	282.0	298.6
% Change*	2.7	0.8	9.4	7.3	5.3	4.9	5.5	6.2	9.2	4.5	5.9

*Compound annual rates

OUTLOOK FOR REAL GROWTH
(Percent Change)

Item	1982				1983				Years		
	IA	IIP	IIIF	IVF	IF	IIF	IIIF	IVF	81A	82F	83F
Gross National Product	–5.1	1.7	1.6	2.8	2.7	2.6	4.5	4.1	1.9	–1.5	2.8
Personal Consumption Expenditures	2.4	3.1	0.6	2.9	2.3	2.2	3.4	2.9	1.8	1.0	2.4
Durable Goods	10.5	4.4	–4.0	7.2	5.8	5.5	8.9	6.7	2.2	–1.1	5.1
Nondurable Goods	–1.0	3.9	2.1	1.8	1.4	1.5	2.2	2.0	1.8	1.1	1.9
Services	3.0	1.9	0.8	2.5	2.0	1.8	2.7	2.4	1.7	1.6	2.0
Gross Private Domestic Investment	–36.5	10.9	6.1	4.0	8.2	7.7	15.2	13.5	8.4	–10.9	8.4
Fixed Investment	–6.0	–6.3	–10.0	–2.0	5.3	4.8	11.5	8.0	1.7	–5.3	1.9
Nonresidential	–5.0	–8.5	–13.9	–7.2	0.3	2.3	9.6	7.8	3.5	–3.8	–1.8
Producers' Durable Equipment	–7.7	–12.8	–11.7	–3.6	4.1	3.3	12.7	9.0	2.4	–5.7	0.5
Structures	1.5	1.5	–18.6	–14.8	–7.9	0.0	2.5	5.1	6.2	0.4	–6.8
Residential	–9.7	3.1	8.4	21.6	26.0	14.2	18.6	8.6	–4.9	–10.9	17.2
Change in Business Inventories ($)	–15.4	–6.9	1.5	4.5	6.0	7.5	9.5	12.5	9.0	–4.0	8.9
Government Purchases	–2.9	–6.3	1.1	0.8	–1.0	–1.0	–0.8	–0.1	0.9	–0.3	–0.7
Federal	–5.4	–16.4	6.0	3.7	0.7	0.0	1.8	1.4	3.7	1.2	0.7
State and Local	–0.9	0.2	–1.6	–0.9	–2.1	–1.4	–2.5	–1.2	–0.8	–1.2	–1.5
Net Exports ($)	36.9	35.6	36.2	37.0	38.0	39.0	40.2	41.5	42.0	36.4	39.7
Exports	–12.6	1.6	3.7	5.3	6.0	5.7	6.9	6.3	–0.5	–3.2	5.4
Imports	–17.6	7.5	2.4	4.1	4.5	4.1	5.0	4.0	7.2	0.4	4.3
Final Sales	0.2	–0.6	–0.7	2.0	2.3	2.2	3.9	3.3	1.0	–0.6	1.9

A = Actual F = Forecast P = Preliminary

quarter. Consumer spending for nondurable goods has been somewhat more robust, and should gain about 2 percent in the second half. Consumer spending for services appeared to slump somewhat during the third quarter, but this category should increase about 2.5 percent in the fourth quarter.

As inflation continues to recede and disposable income and employment gain in the 1983 economy, consumer spending for durable goods is expected to accelerate as purchases of big-ticket items that have previously been deferred begin to be a force in consumer spending. Auto sales are expected to climb back to the 10 million unit annual rate by late 1983, with domestically produced cars accounting for about 75 percent, or 7.5 million, of total sales. Consumption expenditures for nondurable goods and, particularly, services, should also be a source of strength in the 1983 outlook. Purchases of clothing and shoes, expected to rise 4.4 percent, should lead the nondurable goods sector, while the housing category should be the fastest-rising element of services, gaining about 2.9 percent as the housing industry recovers from its prolonged slump.

EMPLOYMENT OUTLOOK

The employment situation in the first seven months of 1982 was dismal, and the unemployment rate will likely average over 9 percent for the year. In July, the jobless rate soared to a post World War II seasonally adjusted record high of 9.8 percent and over 10.5 million persons were out of work. Weak consumer spending and high interest rates had pushed many firms to deepen their budgetary and manpower cuts in the first two quarters. By July, over 8 percent of the adult men in the work force were unemployed. The average unemployment rate for teenagers was above 20 percent and the ratio was even higher for minority groups. Goods pro-

ducing industries and the transportation sector experienced major manpower cutbacks during this recession. As the nation's economy improves in the remainder of 1983, firms and industries are expected to return to a less pessimistic managerial approach. In response to the recent drop in interest rates and the consumer price index, some industries already appear to have slowed the pace of worker layoffs. In the example of the service industries, there was a sign of rehiring in July.

For the next several months, we expect the nation's unemployment rate to linger around 9.5 percent and to decline gradually at an average of about 0.2 percentage point per quarter through the end of 1983. This high employment trend is a reflection of the expanding number of new and re-entrants into the laborforce as well as of a recessionary economy. The laborforce participation rate has grown steadily since the second quarter of 1982. The civilian laborforce should increase at a compound annual rate of 1.6 percent for the next six quarters according to our projections. As in most recessionary periods, many women are re-entering the workforce, and there is an underlying social trend of increasing laborforce participation by women, so that female job-seekers are expected to contribute heavily to the continued laborforce growth through 1983. The sluggish market condition of the goods producing industries, including manufacturing, construction, and mining, will keep employment among blue-collar workers depressed for the rest of 1982. The unemployment rate will be down to 8.5 to 8.8 percent by the end of 1983, and approximately 9.5 to 9.9 million individuals will still be unemployed. The jobless rate will be highest among the northwestern and northeastern states, two areas which rely substantially on the older heavy-manufacturing industries. The uneven distribution of national employment opportunities will continue to encourage jobs seekers to move from the recession-weakened states of the north to the expanding sun-belt areas in the south and southwest regions.

CAPITAL SPENDING OUTLOOK

Business capital spending has been a major casualty of the 1981-82 recession. Real fixed investment, which rose at a 6.3 percent annual rate in the first quarter of 1981, has since been declining progressively. Most recently, real investment fell 6.0 percent at an annual rate in the first quarter of 1982, and 6.3 percent in the second quarter.

Further, the relative contribution of capital investment to Gross National Product has been decreasing. The share of real GNP devoted to business fixed investment has declined from 11.0 percent in 1979 to 10.7 percent in 1981, and is expected to fall to 10.2 percent in 1982. The growth of the nation's nonresidential capital stock has suffered a similar decline. After increasing 4.5 percent in 1979, its growth rate is projected to decrease over 50 percent, and should average just 2.0 percent over 1982 and 1983. The weakness in the capital sector of the economy becomes even more pronounced when one recognizes that private investment in the years preceding the recession was sluggish relative to historical standards. Recent evidence suggests that nonresidential private investment has been declining since the mid-1960's as a percentage of real GNP. This secular change has been primarily the result of the existing tax structure and persistently high inflation rates. These factors distort the net real rate of return on business investment, and have effectively reduced the attractiveness of nonresidential business spending relative to other forms of investment. Thus, it is evident that fixed investment has declined significantly over the last year, even though it was operating off a very low base. This event is particularly paradoxical because the focus of the administration's economic policy is to stimulate private investment, thereby increasing productivity and making the United States more competitive in international markets.

Although the thrust of the President's program could have significant benefits for private investment in the long run, the current environment for business spending is being clouded by the severity of the recession.

Specifically, deterioration in business fixed investment over the last year has been principally a function of weak demand for manufactured goods, and the poor health of corporate balance sheets.

Unemployment, which rose to a post World War II record of 9.8 percent in July, combined with persistently high interest rates, relatively weak gains in personal income, and a lack of consumer confidence have resulted in real final sales declining 0.6 percent annually in the first quarter of 1982, and 0.7 percent in the second quarter. Weakness was especially evident in the highly visible consumer durable sector, as sales of autos and major appliances during the first two quarters of 1982 declined significantly from their 1981 levels. In addition, prices for manufactured goods have decreased markedly. The Journal of Commerce reported that its key index of 15 industrial commodity prices

declined 3.3 percent in June, and has now dropped 20.6 percent over the last year. Although basic prices are expected to stabilize in the third quarter, they should subsequently rise only at modest rates in the fourth quarter.

Weak final demand and soft prices have had two important effects on capital investment. First, they have had a significant impact on the level of manufacturing output. The Index of Industrial Production has declined in eleven of the last twelve months, falling from 152.9 in July 1981 to 138.1 in July 1982. As a result, the amount of idle capacity in the economy has increased substantially. The capacity utilization rate for manufacturers decreased to 69.5 percent in July, and the operating rate for producers of industrial materials dropped to 69.0 percent. These rates were about 10 and 12 percentage points below their year earlier levels, and were close to or below their March 1975 lows. This suggests that the net demand for capital investment has decreased because businesses can expand significantly with their current capital stock. Secondly, current levels of demand, prices, and other measures of economic activity help form businesses' expectations about future activity and capital requirements. Given the current recession, it is reasonable to assume that the present weakness in business spending partially reflects pessimistic expectations.

The deteriorating condition of corporate balance sheets has also had an important negative effect on capital spending. The disinflation process, weak final demand, and extraordinarily high real borrowing costs have resulted in before-tax corporate profits declining 32.2 percent in the first quarter of this year, and an estimated 26.7 percent in the second quarter. As a result, capital investment through internally generated funds has become a less viable option for businesses.

In addition, high interest rates have had a significant effect on businesses' debt structure and corporate policy. Since the fourth quarter of 1979, firms have rolled their maturing bonds over into short-term borrowing in anticipation of a decline in long term-rates. However, persistently high long and short-term rates have resulted in short-term debt and debt service requirements rising to near record levels. Short-term debt currently represents 42 percent of total corporate borrowing, while nearly 50 percent of businesses' cash flow is used to service debt. Thus, the rising burden of corporate debt consumes a significant amount of firms' resources, and effectively limits businesses' ability to expand. Further, high real interest rates create an environment which encourages firms to conserve cash and purchase high-yielding securities, rather than commit funds to long term capital projects.

Given these negative factors, capital spending is expected to demonstrate substantial weakness through 1982. Although cash flow should improve over the balance of the year, it will likely be used to restore liquidity and reduce debt. A significant decrease in equipment spending should result in nonresidential fixed investment declining 3.8 percent in 1982. Weakness will be quite pronounced in the agriculture, auto, and metals industries. This view is generally reflected in the most recent survey of 1982 capital spending plans taken by McGraw-Hill. This study indicates that American businesses will spend just 3.9 percent more on nominal investment in 1982 than they did last year. After adjusting for inflation, expenditures are projected to decline at a 4.5 percent rate over 1982. Moreover, firms' intentions for 1982 capital spending have been scaled down significantly over the past year. In the fourth quarter of 1981, firms expected nominal 1982 capital expenditures to rise 9.6 percent; in the first quarter of 1982, capital spending was projected to increase just 6.7 percent.

Further, recent data on orders for manufactured goods provide little indication of significant positive change in demand. Orders rose 1.5 percent in May, but declined 0.3 percent in June as durable goods orders fell 1.9 percent. In addition, the backlog of unfilled orders decreased 1.3 percent in June, and has declined 11 consecutive months.

The completion of the inventory correction, increased corporate liquidity, and renewed strength in consumer spending should result in a modest capital spending recovery in 1983. Nonresidential fixed investment is expected to record further declines in 1983, although moderate growth is expected from the fourth quarter of 1982 to the fourth quarter of 1983, while residential investment is projected to increase significantly.

REAL CAPITAL SPENDING OUTLOOK
(Percent Change)

	1982				1983				Years	
	IA	IIA	IIIF	IVF	IF	IIF	IIIF	IVF	82F	83F
Fixed Investment	–6.0	–6.3	–10.0	–2.0	5.3	4.8	11.5	8.0	–5.3	1.9
Nonresidential	–5.0	–8.5	–13.9	–7.2	0.3	2.3	9.6	7.8	–3.8	–1.8
Durable Equipment	–7.7	–12.8	–11.7	–3.6	4.1	3.3	12.7	9.0	–5.7	0.5
Structures	1.5	1.5	–18.6	–14.8	–7.9	0.0	2.5	5.1	0.4	–6.8
Residential	–9.7	3.1	8.4	21.6	26.0	14.2	18.6	8.6	–10.9	17.2

Weakness in the nonresidential plant and equipment sector is primarily a function of a substantial decrease in structures investment, which declines 6.8 percent. Lackluster performance in this category is the result of a surplus of office space in major urban areas. Contracts have fallen below activity for the first time since mid-1980, and vacancy rates in 17 large cities are approaching 10 percent.

Improving profits and balance sheets should result in manufacturers increasing real equipment investment modestly. Spending in this category should rise 5 percent from the fourth quarter of 1982 to the fourth quarter of 1983.

Relative strength in residential investment, which is expected to increase 17.2 percent in 1983, largely reflects a moderate housing recovery. Private housing starts, which have been recorded at an annual rate of 902,400 over the first two quarters of 1982, are projected at 1.3 million for 1983. The increase in residential construction results from a modest decline in mortgage rates, and a favorable demographic environment.

Preliminary data indicate that the inventory correction continued in the second quarter of 1982. After declining $15.4 billion in the first quarter, real inventories decreased an additional $6.9 billion in the second quarter. The significant declines reflected a large decumulation in auto inventories. Auto sales in May were relatively strong as a result of rebates and attractive financing, while production levels declined to less than 50 percent of capacity. As a result, inventory stocks relative to sales have improved. The manufacturing and trade inventory-to-sales ratio declined from 1.50 in December 1981 to 1.45 in June 1982. Similarly, the inventory-to-sales ratio for durable goods firms declined from 2.14 in December 1981 to 2.09 in June of this year.

The present inventory liquidation combined with a gradual recovery in consumer spending should foster moderate inventory rebuilding over the rest of 1982, and through 1983. Real inventories are expected to decline $4 billion in 1982, and increase $8.9 billion in 1983.

CORPORATE PROFITS

During the first half of the year, corporate profits averaged approximately 30 percent below the comparable period of 1981. The first quarter's decline of 32 percent from the prior year was the largest quarterly decline in the post-World War II period and took before-tax profits to the lowest level since the fourth quarter of 1976. Previously, the largest year-over-year drop had occurred in the first quarter of 1975, when before-tax profits fell 16 percent. Operating profits for the first half of the year averaged approximately 20 percent below year-ago levels. In the second quarter, operating profits were at the lowest level since the first quarter of 1977.

The larger decline in before-tax profits reflects the substantial declines in two adjustment factors: the inventory valuation adjustment and the capital consump-

tion adjustment. The first-half deceleration of inflation, and some cases actual declines in prices, along with substantial inventory reduction reduced the difference between the book value of inventories and their replacement value, thereby reducing the level of inventory profits. Also, the Accelerated Cost Recovery System (A.C.R.S.) adopted in the Economic Recovery Tax Act of 1981 has permitted businesses to expense a greater share of the economic depreciation of their capital equipment. Before-tax profits are correspondingly reduced.

Throughout 1983, corporate profits are expected to increase as the economy recovers and expands. A less than average rate of economic growth is expected to produce a less than average rebound in corporate profits. Even though before-tax and operating-profits are expected to rise in the second half of this year, both would be below their respective levels for the second half of 1981. Furthermore, although before-tax profits are expected to rise steadily, reaching 7 percent of GNP by the end of the forecast period, they would still be below the level of the first quarter of last year. Inventory profits will increase as inventory building resumes in the second half of the year and price increases stabilize around 6 percent. In contrast, as a result of A.C.R.S., book depreciation for tax purposes is expected to overstate the true depreciation of capital in 1983. As a result, before-tax profits would be understated by several billion dollars by the end of 1983.

For nonfinancial corporations, operating profits came under considerable pressure in the first half of 1982, as both profit margins and the level of real output declined. The rate of increase in unit labor costs slowed in the first quarter despite an acceleration in the increase of compensation per hour because of a substantial increase in productivity. The quarterly increase in unit labor cost is expected to remain below a 6 percent annual rate over the forecast period, as the increase in wage rates slows in response to the slower increase in consumer prices. The sluggish pace of economic recovery, however, precludes sustained quarterly productivity increases in excess of an annual rate of two percent.

CORPORATE PROFITS OUTLOOK

	$ Billions			Percentage Change		
	1981A	1982F	1983F	1981	1982	1983
Operating Profits	$190.6	$164.8	$214.1	4.9	–13.6	29.9
Corporate Profits Before Taxes	232.1	178.8	228.4	–4.3	–22.9	27.7
Corporate Profits After Taxes	150.9	124.2	159.1	–4.4	–17.7	28.1
Book Depreciation	189.4	222.9	259.9	15.9	17.7	16.6
Gross Cash Flow	340.3	347.1	419.0	6.0	2.0	23.1
Dividends	65.1	70.9	80.6	12.1	9.0	13.6
Cash Flow Less Dividends	275.2	276.2	338.4	4.6	0.4	22.5
Capital Consumption Adjustment	–16.8	–5.6	0.8	—	—	—
Inventory Valuation Adjustment	–24.6	–8.4	–15.2	—	—	—
Operating Profits/GNP	6.5%	5.3%	6.3%	—	—	—
Before-Tax Profits/GNP	7.9%	5.8%	6.8%	—	—	—
Nonfinancial Corporations:						
Compensation per hour	—	—	—	9.7%	8.5	6.9
Productivity	—	—	—	1.8	1.1	1.8
Unit Labor Cost	—	—	—	7.8	7.4	5.1

Profits of financial corporations have declined consistently since the fourth quarter of 1978, when both domestic and international financial pressures brought about increases in interest rates. More recently, increased profits at Federal Reserve banks and commercial banks have been offset by increased losses at thrift institutions. During the last half of 1981, losses at insured savings and loans institutions totaled $3.1 billion. During that period, the average return on their mortgage portfolios was 10.02 percent, reflecting the large proportion of older, low rate loans. At the same time, the average costs of funds was 11.53 percent. Over the period ahead, total profits of financial corporations should show modest improvement. Although the thrift industry will continue to experience losses, the lower level of interest rates projected for 1983, should prevent significant further increases in their average cost of funds.

INFLATION PERFORMANCE

One of the most significant economic changes of the last year has been the rapid improvement in the nation's rate of inflation. After rising 9.5 percent in 1981, inflation, as measured by the GNP fixed-weighted price deflator, rose 4.8 percent in the first quarter of this year, and 4.6 percent in the second quarter. The GNP implicit price deflator, which increased 9.4 percent in 1981, gained 4.3 percent in the first quarter of 1982, and 5.4 percent in the second quarter. Similarly, the Consumer Price Index, which rose 13.5 percent in 1980 and 10.3 percent in 1981, advanced at a 3.2 percent annual rate in the seven-month period ended in April 1982.

The dramatic improvement in the inflation rate has essentially been a function of the recession, a global petroleum surplus, more moderate wage settlements, weak agricultural prices, and the dollar's appreciation against foreign currencies. Moreover, the downward trend in inflation reflects the Federal Reserve's success in controlling the growth of the nation's money supply.

However, the battle against inflation is not over. The most recent evidence indicates that inflation has resurfaced at double-digit rates in both retail and wholesale prices. The Consumer Price Index rose at a 13.3 percent annual rate in May and June, following a 2.2 percent annual increase in April, and a 3.5 percent annual decline in March. Similarly, the Producer Price Index rose at a 13.3 percent rate in June, after increasing just 0.6 percent annually in the April-May period.

The sudden advance in inflation was not characterized by a general return to higher prices, but rather reflected sharply higher energy and housing costs. Retail gasoline prices, which had declined almost 15 percent over the period from March 1981 through April 1982, rose nearly 1 percent in May, and 5.4 percent in June. The surge in prices was almost exclusively due to OPEC's decision to reduce the worldwide petroleum surplus. The cartel began limiting crude oil production to 17.5 million barrels per day in April 1982, compared to 31.0 million barrels per day in 1979. As a result, excess oil inventories were quickly liquidated, and both wholesale and retail prices for energy goods rose markedly.

Housing price inflation, which slowed markedly over the last year, rose 2.6 percent in May and 2.3 percent in June. Although these increases had a pronounced impact on the Consumer Price Index, they may not accurately reflect current housing market conditions. Many buyers are agreeing to higher prices in order to gain more attractive financing, and the price index does not reflect the implicit price of "creative financing". Furthermore, the reported price increases may reflect quality differences in the monthly sample of homes.

Both of these events provide evidence that the economy cannot yet sustain a 4 percent to 5 percent inflation rate on a long-term basis. However, it is expected that the recent surges in inflation are of a transitory, rather than permanent nature.

Security Pacific Bank's forecast shows the GNP price deflator rising moderately over the third and fourth quarters to 7 percent, and subsequently increasing at a 6.6 percent rate in 1983. The Consumer Price Index should rise at a 10 percent annual rate in the third quarter, reflecting sharply higher energy prices, and will likely average 6.5 percent over 1983.

A return to stable oil prices should moderate inflationary pressures over the forecast period. Although OPEC was quite successful in reducing the global petroleum surplus and raising prices in the second quarter, the cartel was not able to agree on pricing or production levels at their July 1982 meeting. As a result, world crude oil prices have softened, and several cartel members have increased production. In response, it now

INFLATION OUTLOOK
(Percent Change)

	1982				1983				Years	
	IA	IIA	IIIF	IVF	IF	IIF	IIIF	IVF	82F	83F
GNP Price Deflator	4.3	5.3	7.2	7.0	6.7	6.3	5.7	6.3	6.6	6.5
Consumer Price Index	3.2	4.6	10.0	6.0	6.2	5.3	5.8	6.2	6.6	6.3
Consumer Price Index — Food & Beverages	4.6	4.1	7.2	6.9	6.8	5.5	5.3	5.6	4.9	6.3
Personal Consumption Deflator — Energy	-4.0	-11.8	19.3	5.8	8.0	7.7	7.4	6.9	0.9	7.4

appears that world oil markets are approaching an equilibrium, and that retail prices should stabilize over the remainder of the year. As the economy recovers in 1983, world oil demand will increase moderately, and could create an environment which would result in significantly higher crude oil prices. However, excess capacity in the oil producing countries, combined with an energy efficient capital stock should temper world oil price increases through 1983. Modest petroleum price inflation will be somewhat offset by double-digit increases in the prices of natural gas and electricity. Natural gas prices should increase 15 percent in 1982, and 12.5 percent in 1983. Electricity prices are projected to rise 11 percent in 1982, and 9.1 percent in 1983.

Food price inflation should be relatively modest through 1983. The Index of Prices received by farmers, which reflects wholesale agricultural prices, was unchanged in early July, and declined 0.7 percent in June. This should result in generally flat retail food prices in the near term. Preliminary evidence suggests that 1982 will be another year of bumper crops. In early June, plantings of wheat, corn, and feed grains were marginally below 1981 record levels, while soybean plantings increased. A large 1982 harvest, coupled with excess inventories, should result in plentiful grain supplies over the forecast period. This should quell inflationary pressures for cereal and bakery goods, as well as reduce the cost of livestock production. In contrast, meat prices have rebounded significantly as farmers have trimmed inventories and output. However, higher prices combined with depressed feed grains costs should lead to increased livestock production in 1983. As a result, meat supplies should increase, thus moderating food price inflation.

Slack industrial capacity and continued high unemployment should also prove to be stabilizing influences on inflation through 1983. Manufacturing capacity utilization dropped to 69.5 percent in July, its lowest rate since March 1975, and is expected to rise to only 75 percent in 1983. This would suggest that industrial output can expand substantially without encountering any significant cost pressures. Furthermore, some manufacturers have recently developed new policies which require their suppliers to bid for contracts. This would end the practice of manufacturers paying list prices for their inputs, and would ultimately increase competition among producers of crude and intermediate materials. As a result, the prices of these goods should more accurately reflect market conditions. Moreover, the use and acceptance of these types of policies would introduce an important measure of wage and price flexibility into an economy that has come to be dominated by downwardly rigid prices.

Recent modest wage settlements reflect rising unemployment and the deteriorating profitability of private industry. The adjusted hourly earnings index rose at a 6.2 percent annual rate over the first six months of 1982, compared to an 8.2 percent increase during 1981. Over 1983, wages are expected to grow at a 6.5 percent rate. This trend, in addition to higher labor productiv-

ity, will be of significant importance in controlling unit labor cost. Productivity is increasing as "baby boom generation" workers enter a more productive stage in their career cycle, and business expands capital spending in 1983. Productivity is also aided by the growing trend toward labor concessions. In many industries, employees have agreed to work longer hours, and give back paid holidays and other benefits. Although these concessions began in the financially plagued auto and airline industries, it is expected that competitive pressures will help these practices to spread to relatively healthy industries as well.

On average, prices of natural resources are projected to grow at a significant rate through 1983. A modest recovery in residential construction should push lumber and building supply prices 9 percent higher. Similarly, non-ferrous metal prices are expected to increase from their current depressed levels as the economic recovery advances and demand for these goods increases. In addition, chemical producers, who have absorbed recent costs in energy and labor prices, will likely raise prices 7 percent to 8 percent.

Inflation expectations, which are an important factor in determining future inflation rates and economic activity, have become significantly lower. This has not only been reflected in moderate wage settlements, but in the current and future prices of precious metals and personal investments. The prices of silver and gold, which skyrocketed during the inflationary 1970's, have recently plunged to fractions of their previous value. Furthermore, the future prices of these metals do not indicate any extraordinary price appreciation over 1983. Similarly, the prices of antique furniture, art, and other collectables have also declined significantly. In many cases, these prices have decreased 50 percent or more.

However, not all factors reflecting expectations have declined markedly. The persistence of real interest rates at historically high levels suggests that a segment of financial market participants anticipates significantly higher long-term inflation rates.

The key element in achieving a modest rate of inflation will be the Federal Reserve's ability to maintain moderate, steady growth of the money supply in light of the record budget deficit. Given the central bank's recent policies, and renewed congressional efforts towards reducing the deficit, it is reasonable to assume that the United States will not soon return to another era of double-digit inflation.

INTERNATIONAL DEVELOPMENTS

The growth trend for both U.S. exports and imports will be relatively undramatic through year-end 1983, and the balance of international transactions will show only a small improvement. The "net exports" component of U.S. national accounts, which includes trade in both goods and services, has dropped from a $48 billion annualized surplus in the first quarter of 1981 to a $35.6 billion surplus in the second quarter of 1982. A progressive, but slight, strengthening of that balance is forecast through the fourth quarter of 1983, when it should reach a $41.5 billion rate.

The improvement in the net exports is mainly because of the slowness of the recovery of the U.S. economy from its current weakness, the impact of which will be to moderate U.S. import growth. Additionally, the slight economic recoveries which major U.S. trading partners will experience reinforce the improving trend from the side of exports. In other words, this forecast does not subscribe to the "wipe-out" theory, which some observers — basing their projection primarily on the competitive impact of the appreciation of the U.S. dollar during 1981 and into 1982 — feel will bring dire consequences for U.S. trade and the net exports position. Our contrary view is supported by the expectation that income trends will prove more powerful than price trends. Additionally, oil price forecasts, including a drop in nominal prices in 1983, and ongoing advances in energy efficiencies forced by oil price decontrol, will continue to have a favorable impact on oil imports.

The dollar is therefore expected to remain relatively strong during the rest of 1982, particularly if interest rate levels rise in the final months of the year. During 1983 the dollar will begin to decline in an undramatic fashion, which should by year-end reduce some of the negative impact that the dollar's earlier appreciation may have had on the trade balance. Hence, in total, we remain bullish on the dollar, given our expectations for the U.S. trade and inflation performances, coupled with the uncertain political situations in much of the rest of the world. ■